February
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Reducing the Deficit: Spending and Revenue Options

A Report to the Senate and House Committees on the Budget —Part III

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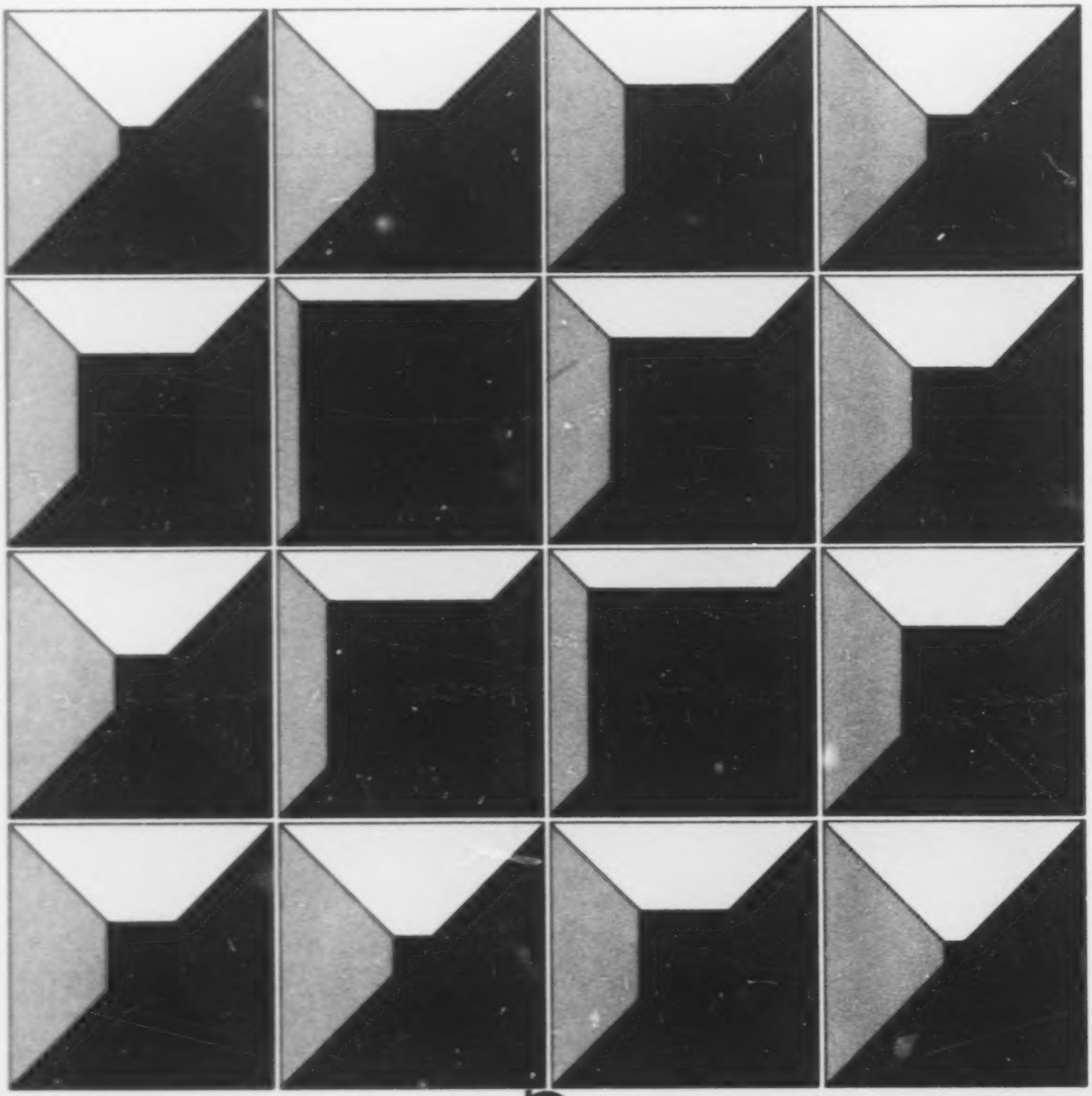

CONGRESS OF THE UNITED STATES

CONGRESSIONAL BUDGET OFFICE

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REDUCING THE DEFICIT:

SPENDING AND REVENUE OPTIONS

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise noted, all years referred to in this report are fiscal years. Likewise, unless otherwise noted, all dollar amounts are expressed in current dollars.

Details in the text, tables, and figures of this report may not add to the totals because of rounding.

The Omnibus Budget Reconciliation Act of 1981 (Public Law 97-35) is referred to in the text as the Reconciliation Act of 1981 and the Omnibus Budget Reconciliation Act of 1982 (Public Law 97-253) as the Reconciliation Act of 1982. Similarly, the Economic Recovery Tax Act of 1981 (Public Law 97-34) is referred to as ERTA and the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248) as TEFRA.

PREFACE

The Congressional Budget Office (CBO) is required by section 202(f) of the Congressional Budget Act of 1974 to submit an annual report on budgetary options to the Senate and House Committees on the Budget. This year, the report is in three parts, with this report constituting Part III. Part I is entitled The Outlook for Economic Recovery; Part II is Baseline Budget Projections for Fiscal Years 1984-1988. To provide background information for the Congressional debate on the fiscal year 1984 budget, this report examines alternative broad strategies for reducing the federal deficit and analyzes various specific options for cutting budget outlays and raising revenues over the 1984-1988 period. The inclusion of an option in this report, or the omission of one, does not imply a recommendation by CBO. In accordance with CBO's mandate to provide objective and impartial analysis, this report contains no recommendations.

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Alice M. Rivlin
Director

February 1983

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CHAPTER I. INTRODUCTION AND OVERVIEW

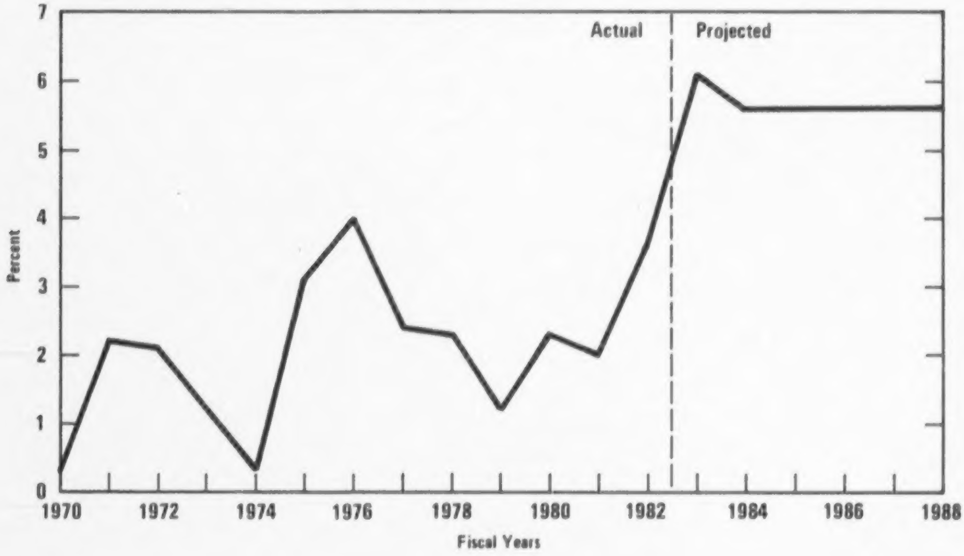
The American economy faces unprecedented risks in the years ahead unless the federal government takes measures to narrow the gap between tax revenues and spending. The Congressional Budget Office (CBO) has projected outlays and revenues in coming years, assuming no changes in current laws and policies. These "baseline" projections show federal deficits increasing from $194 billion in 1983 to $267 billion by 1988 (see Table I-1).

Even when gauged in relation to a growing gross national product (GNP), the size of these deficits is startling. For 1983 and 1984, CBO projects postwar record deficits amounting to 6.1 and 5.6 percent of GNP, respectively (see Figure I-1). To a great extent, these near-term deficits are attributable to the economic recession, which has reduced federal revenues and increased federal outlays for unemployment compensation and other income maintenance programs. But even as these cyclical causes wither as economic recovery proceeds, the projected deficits remain at the high level of 5.6 percent of GNP throughout the 1984-1988 period. This indicates a long-term mismatch between federal spending and taxing.

TABLE I-1. BASELINE BUDGET PROJECTIONS

	Actual			Estimated	Baseline Projection				
	1980	1981	1982	1983	1984	1985	1986	1987	1988
In Billions of Dollars									
Outlays	577	657	728	800	850	929	999	1,072	1,145
Revenues	517	599	618	606	653	715	768	822	878
Deficit	60	58	111	194	197	214	231	250	267
As a Percent of GNP									
Revenues	20.1	20.9	20.4	19.0	18.7	18.7	18.5	18.4	18.3
Outlays	22.5	22.9	24.0	25.0	24.3	24.3	24.1	24.0	23.9
Deficit	2.1	2.0	3.6	6.1	5.6	5.6	5.6	5.6	5.6

Figure I-1.
Federal Deficit as a Percentage of GNP



This budget outlook is based on CBO's most recent economic forecast for 1983-1984 and on what are believed to be reasonable assumptions for ensuing years. Real economic growth is expected to resume at a moderate pace in 1983, lowering the unemployment rate to 7.6 percent by 1988. Inflation is expected to continue to recede and to stabilize at around 4 percent a year (see Table I-2 and Figure I-2). 1/

STRUCTURAL DEFICITS AND THEIR CONSEQUENCES

The prospect of continuing large federal deficits even after five years of economic recovery is cause for alarm. In a deep recession, the growth of federal debt is usually funded in the capital market from savings that have no other outlet because business, consumer credit, and mortgage demands are at a low level. But as the economy recovers, private demands for credit will increase, leading to competition for funds between federal and private borrowers. Since total credit in the economy tends to remain at a fairly

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1. For further discussion see Congressional Budget Office, The Outlook for Economic Recovery (February 1983), Chapter III, and Baseline Budget Projections for Fiscal Years 1984-1988 (February 1983), Chapter II.

Figure I-2.
Major Economic Assumptions

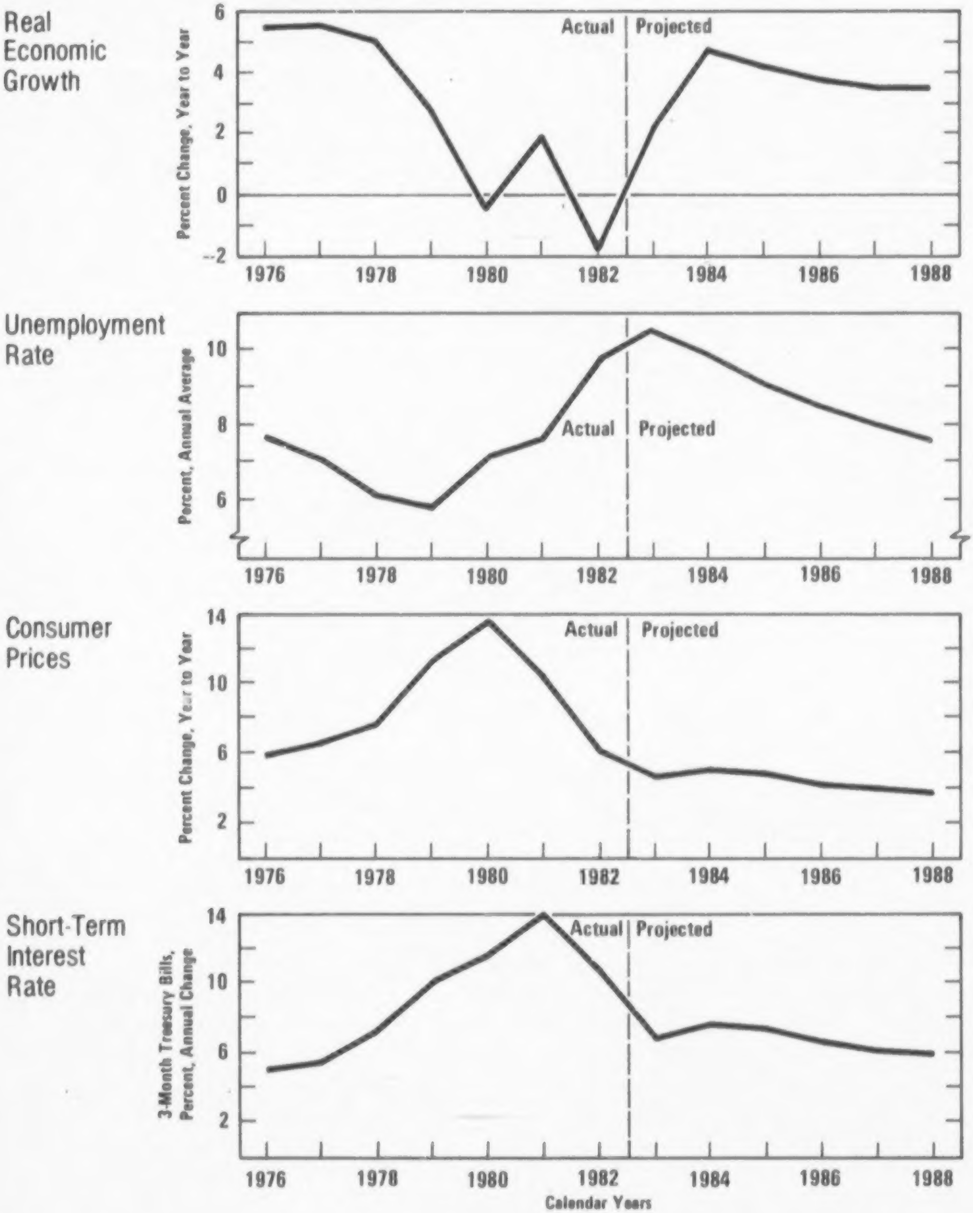


TABLE I-2. BASELINE ECONOMIC FORECAST AND ASSUMPTIONS

Economic Variable	1982	1983	1984	1988
	Fiscal Year Average			
Nominal GNP (billions of dollars)	3,033	3,197	3,499	4,792
Real GNP (billions of 1972 dollars)	1,480	1,492	1,559	1,808
Unemployment Rate (percent)	9.1	10.7	10.1	7.6
Interest Rate (91-day Treasury bills, percent)	11.6	7.0	7.3	5.9
	Percent Change, Fourth Quarter to Fourth Quarter a/			
Nominal GNP	3.3	8.9	9.6	7.9 b/
Real GNP	-1.2	4.0	4.7	3.6 b/
GNP Deflator	4.6	4.7	4.6	4.1 b/
Consumer Price Index	4.5	4.8	4.8	4.0 b/

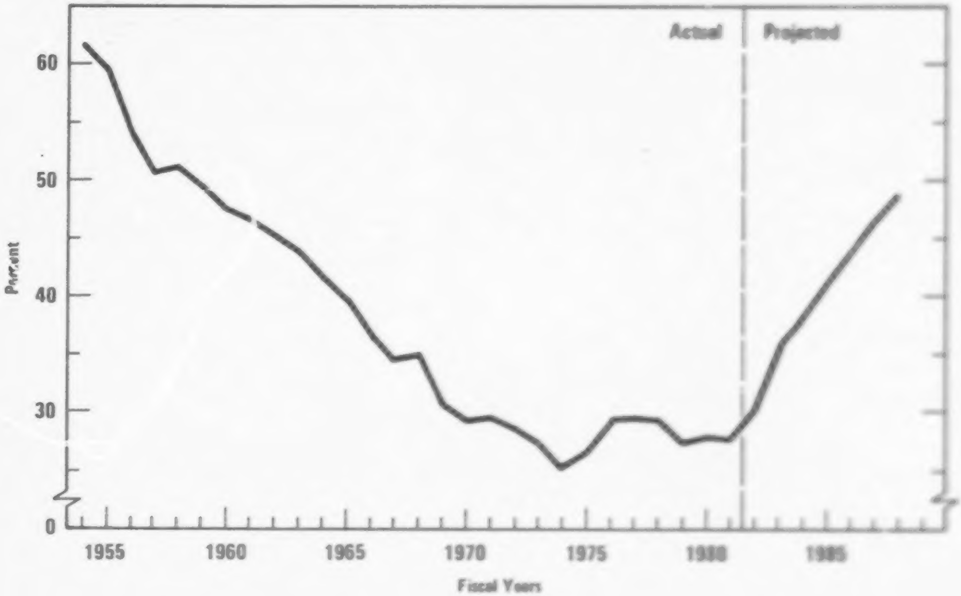
a/ Fourth quarter of the calendar year.

b/ Average over four years ending in fourth quarter of 1988.

steady percentage of GNP, any increase in the ratio of federal debt to GNP threatens to "crowd out" other credit claimants. Intense competition for loanable funds would drive up real interest rates and increase the risk of aborting economic recovery. Even if the recovery continued, high interest rates would discourage the business investment in plant and equipment regarded as vital to improvements in productivity and economic growth. The projection of large government deficits in a period of economic recovery suggests that too small a share of GNP may be left for private investment, thereby limiting future standards of living and American competitiveness in the world economy.

Figure I-3.

Federal Debt Held by the Public as a Percentage of GNP



The CBO baseline projections show the magnitude of the increasing draft on credit markets implicit in current budget policy (see Table I-3). Federal borrowing to finance the deficit--and to finance the spending of off-budget entities, mostly credit institutions that lend to on-budget agencies--is projected to remain about 6 percent of GNP during the next five years (about double the average percent in 1975-1979, another recovery period). This level of borrowing means that the federal debt held by the public will grow faster than GNP, rising from 31 percent of GNP in 1982 to 50 percent by the end of 1988 (see Figure I-3). By contrast, the debt-to-GNP ratio fell steadily from the end of World War II to the early 1970s and remained level over the decade of the 1970s. The last time the ratio was 50 percent was 1959. The projection of a rising trend of federal debt in relation to GNP implies that nonfederal borrowers will have less access to capital. A budget policy conducive to private investment would show precisely the opposite trend.

HOW BIG IS THE PROBLEM?

There is no agreement about exactly how sensitive investment-related borrowing is to federal deficits. Economists have attempted to develop

TABLE I-3. FEDERAL BORROWING AND DEBT

	1982	1983	1984	1985	1986	1987	1988
			In Billions of Dollars				
Unified Budget Deficit	111	194	197	214	231	250	267
Off-Budget Deficit	17	17	15	16	19	17	17
Total Deficit	128	210	212	231	250	267	284
Other Means of Financing a/	7	-11	--	--	--	--	--
Borrowing from the Public	135	199	212	231	250	267	284
			As a Percent of GNP				
Borrowing from the Public	4.5	6.3	6.1	6.0	6.0	6.0	5.9
Federal Debt Held by the Public (end of year)	30.6	35.3	38.3	41.1	43.9	46.8	49.5

NOTE: Details may not add to total because of rounding.

a. Change in monetary assets and other adjustments.

guidelines for budget policy based on a variety of criteria--such as preventing increases in the ratio of federal debt to GNP, freezing the level of the inflation-adjusted debt, and limiting federal deficits computed at a standardized rate of employment. The economic rationales for some of these alternatives are discussed in a companion report. 2/ Broadly, the guidelines suggest that the cumulative reduction in federal debt over the 1984-1988 period should be in the range of $400 billion to $1,000 billion, or that the reduction of the deficit in 1988 from the projected baseline level should be on the order of $100 billion to $200 billion. Reaching these objectives would reduce the 1988 deficit from the projected $267 billion to between $50 billion and $150 billion, and would curb the increase in the ratio of debt outstanding to GNP.

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2. See CBO, The Outlook for Economic Recovery, Chapter IV.

A simple way to grasp the dimensions of the budget problem is as follows. In 1988, a year in which unemployment is expected to average 7.6 percent, CBO projects the federal deficit at 5.6 percent of GNP. The last year in which unemployment was roughly comparable was 1981, when it averaged 7.4 percent. In that year, the deficit represented only 2.0 percent of GNP. Thus, between 1981 and 1988--two years of roughly comparable employment rates--the deficit is expected to rise by 3.6 percentage points of GNP. This increase, not related to the business cycle and thus "structural," amounts to about $170 billion at projected 1988 GNP. As noted, other guidelines for reducing the deficit might be chosen, but the $170 billion figure is near the middle of the range cited above. If the projected deficit in 1988 were reduced by $170 billion, it would total about $100 billion, or 2 percent of GNP.

POTENTIAL SOURCES OF DEFICIT REDUCTIONS

Finding $170 billion in deficit-reducing measures by 1988 will not be easy. The annual rate of the domestic budget cuts in the first year of the Reagan Administration was about $40 billion, and the hard-fought tax increases of the second year realized an average annual gain of about $33 billion. To achieve an even more ambitious deficit reduction goal will require reconsidering all parts of the budget and the tax base. Any reduction in spending will be perceived as entailing losses to some groups and will therefore involve difficult political choices. To clarify these choices, this section summarizes the composition of the current budget as it has evolved and as it will evolve in coming years if tax and spending policies are not changed. [3]

Federal spending can be divided in different ways. Congressional budget resolutions, for example, break down the budget into 19 functional categories such as health and transportation. But an overview of the budget is made easier by grouping programs into five categories: national defense, entitlement and other mandatory spending programs, nondefense discretionary spending, net interest, and offsetting receipts. Those program categories are described in the box on page 8

Federal Spending, 1965-1980. Between 1965 and 1980, total outlays rose from 18 percent to 22.5 percent of GNP (see Table I-4). Entitlements and other mandatory programs--largely Social Security, Medicare, Medicaid, and other benefits--advanced even more sharply, rising from 5 percent of

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3. For a more detailed discussion, see CBO, Baseline Budget Projections for Fiscal Years 1984-1988.

FEDERAL BUDGET CATEGORIES

National Defense. Outlays for military and civilian personnel, operating costs, major weapons procurement, and military retirement benefits. Military and civilian workers' pay increases are included in the projections. (Chapter II)

Entitlements and Other Mandatory Spending. Programs in which spending is governed by a law making all who meet their requirements eligible to receive payments. Subcategories are:

> **Social Security.** Old-age, survivors, and disability benefits only. Medicare is in the next category and administrative expenses are in the nondefense discretionary category. (Chapter III)
>
> **Medicare and Medicaid.** Does not include state share of Medicaid expenditures. Federal administrative expenses for Medicare are in the nondefense discretionary category. (Chapter IV)
>
> **Farm Price Supports.** All outlays of the Commodity Credit Corporation for farm price support and related programs. (Chapter VI)
>
> **Other Entitlements.** Entitlements and other mandatory spending not included above or in "Net Interest." Major examples are Aid to Families with Dependent Children, Black Lung compensation, railroad retirement, federal civilian employee retirement, Guaranteed Student Loans, human services block grants, Supplemental Security Income, unemployment compensation, veterans' compensation and pensions, and General Revenue Sharing. The Food Stamp program has also been included in this category. (Chapter V)

Nondefense Discretionary Spending. All nondefense programs for which spending is determined by annual appropriations. The basic governmental legislative, judicial, and tax-collecting functions are included. A large part of this category represents the salary and expense accounts that finance the ongoing operations of the civilian agencies of government. Most grants to state and local governments (other than for benefit payments), nondefense research and development, and loans subject to appropriation limits are also in this category. (Chapters VII, VIII)

Net Interest. Interest payments on the federal debt less interest received by trust funds.

Offsetting Receipts. Proprietary receipts from the public and the employer share of employee retirement. Other receipts (for example, foreign military sales, trust fund receipts, and payments to trust funds) appropriately netted against outlays are included in the relevant categories above. (Chapter IX)

TABLE I-4. COMPOSITION OF FEDERAL SPENDING, 1965-1980

Category	1965	1970	1975	1980
	As a Percent of GNP			
National Defense	7.2	8.1	5.8	5.3
Entitlements and Other Mandatory Spending				
Social Security benefits	2.6	3.0	4.2	4.5
Medicare and Medicaid	a/	1.0	1.5	1.9
Farm price supports	0.4	0.4	b/	0.1
Other entitlements	2.1	2.2	4.5	4.0
Subtotal	5.2	6.7	10.2	10.5
Nondefense Discretionary Spending	4.7	4.5	5.1	5.5
Net Interest	1.3	1.5	1.6	2.0
Offsetting Receipts	-0.5	-0.6	-0.8	-0.8
Total	18.0	20.2	21.9	22.5
	As a Percent of Total Outlays			
National Defense	40.1	40.2	26.4	23.6
Entitlements and Other Mandatory Spending				
Social Security benefits	14.4	15.0	19.3	20.1
Medicare and Medicaid	a/	5.1	6.6	8.4
Farm price supports	2.3	1.9	0.2	0.5
Other entitlements	12.2	11.1	20.5	17.6
Subtotal	28.9	33.1	46.6	46.6
Nondefense Discretionary Spending	26.4	22.3	23.4	24.5
Net Interest	7.3	7.4	7.2	9.1
Offsetting Receipts	-2.5	-2.9	-3.5	-3.7
Total	100.0	100.0	100.0	100.0

NOTE: Details may not add to totals because of rounding.

a. Predecessor programs counted in other entitlements.
b. Less than 0.1 percent.

GNP to over 10 percent (see Figure I-4). The sharpest increases in this part of the budget occurred in the early 1970s as the result of legislated increases in Social Security and the expansion or creation of such programs as Food Stamps, Medicare and Medicaid, Supplemental Security Income, and General Revenue Sharing. Significant growth also took place in the nondefense discretionary programs during this period, as many grant-in-aid programs were expanded and as federal employees' pay was raised to achieve parity with pay in the private sector.

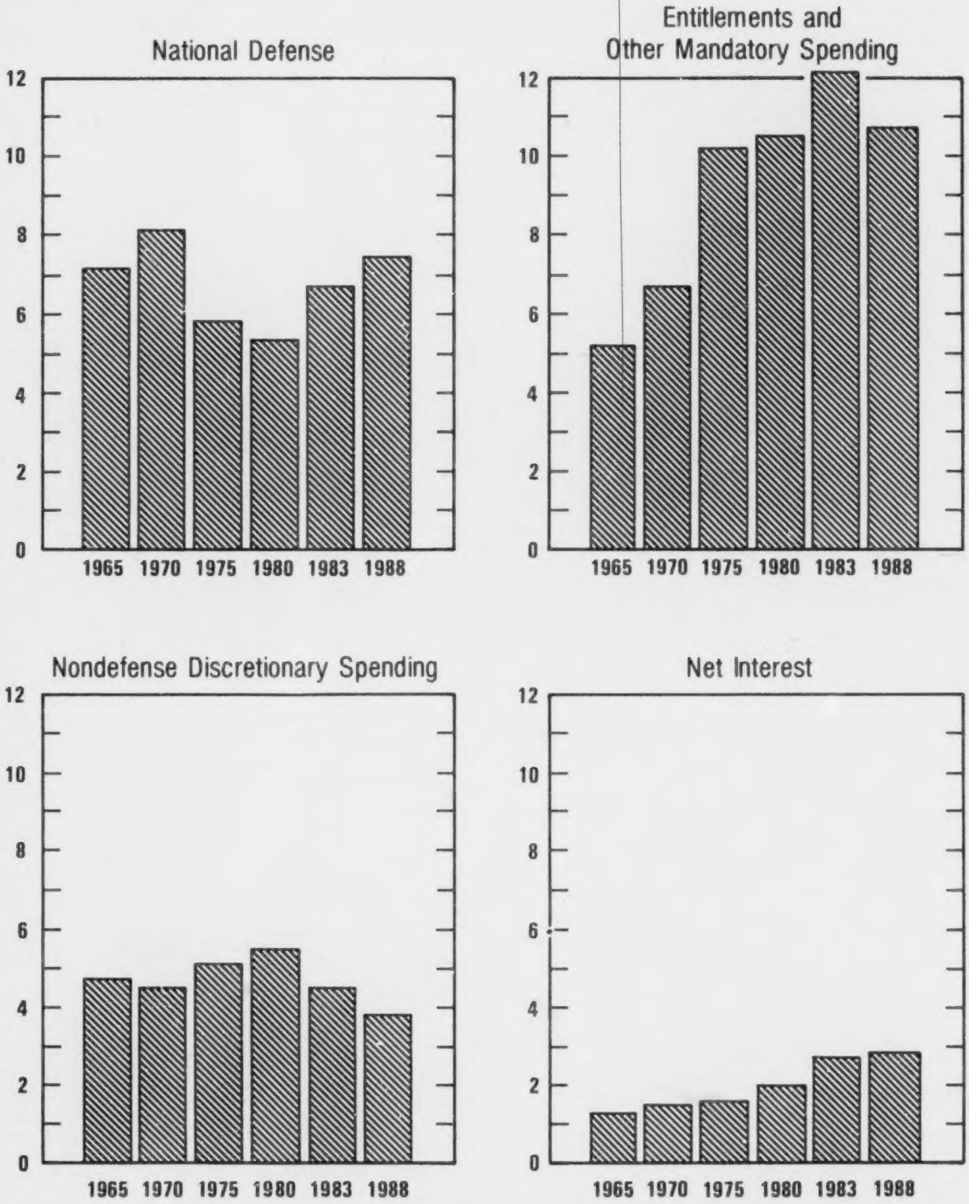
Reductions in the share of GNP devoted to national defense offset about one-third of the growth in entitlement and nondefense discretionary programs. Except for an upward surge of spending for the Vietnam War in the late 1960s, national defense outlays continued a long-term decline that began after the Korean War (when defense outlays accounted for nearly two-thirds of federal spending) and lasted until 1980 (when the defense share fell to less than one-quarter of total outlays).

By the late 1970s, the growth of the GNP share of entitlements had slowed, and the continued growth of federal spending in relation to GNP during the latter half of the decade came from continued expansion of nondefense discretionary programs and higher net interest outlays. The expenditures for interest were driven primarily by the large increases in interest rates of the period.

Federal Spending, 1980-1983. Recent budget trends point up the difficulty in containing federal spending. In just three years, from 1980 to 1983, federal outlays in relation to GNP rose another 2.5 percentage points--from 22.5 percent of GNP to 25.0 percent (see Table I-5). Each year set a new postwar high for federal spending in relation to GNP. The rise in spending is attributable to several factors. First, the long slide in defense spending relative to GNP was halted in the late 1970s; the defense share turned up sharply in the early 1980s. Second, the slower growth of entitlement programs in the late 1970s was reversed in the 1980-1983 period when indexation of these programs to the Consumer Price Index (or in the case of health programs, growth due to medical care inflation) caused an upsurge of spending that outstripped the growth of GNP. By 1983, unemployment compensation and other transfers that increase during recession, together with higher outlays for farm price supports, were also swelling the budget. Third, the share of spending for net interest rose sharply, not only because of higher interest rates but also because of rapid increases in the debt (caused by deficits both on- and off-budget). Finally, the recession and decline in inflation in 1982 and 1983 imposed a heavy drag on the growth of GNP, thereby raising the spending ratios.

Figure I-4.

Outlay Categories as Percentages of GNP



National Defense

Entitlements and Other Mandatory Spending

Nondefense Discretionary Spending

Net Interest

TABLE I-5. COMPOSITION OF FEDERAL SPENDING, 1980-1988

Category	1980	1982	1983	1984	1988
			As a Percent of GNP		
National Defense	5.3	6.2	6.7	6.9	7.5
Entitlements and Other Mandatory Spending					
Social Security benefits	4.5	5.0	5.3	5.1	4.9
Medicare and Medicaid	1.9	2.2	2.4	2.4	3.0
Farm price supports	0.1	0.4	0.6	0.3	0.1
Other entitlements	4.0	3.7	3.9	3.4	2.7
Subtotal	10.5	11.4	12.1	11.2	10.7
Nondefense Discretionary Spending	5.5	4.6	4.5	4.4	3.8
Net Interest	2.0	2.8	2.7	2.7	2.8
Offsetting Receipts	-0.8	-0.9	-1.0	-1.0	-0.9
Total	22.5	24.0	25.0	24.3	23.9
			As a Percent of Total Outlays		
National Defense	23.6	25.7	26.7	28.5	31.3
Entitlements and Other Mandatory Spending					
Social Security benefits	20.1	21.0	21.0	21.1	20.3
Medicare and Medicaid	8.4	9.2	9.5	10.1	12.4
Farm price supports	0.5	1.6	2.2	1.1	0.4
Other entitlements	17.6	15.5	15.6	14.0	11.5
Subtotal	46.6	47.1	48.2	46.3	44.6
Nondefense Discretionary Spending	24.5	19.1	18.2	18.0	16.1
Net Interest	9.1	11.6	10.9	11.2	11.7
Offsetting Receipts	-3.7	-3.7	-4.0	-4.0	-3.6
Total	100.0	100.0	100.0	100.0	100.0

NOTE: Details may not add to totals because of rounding.

The only significant recent spending change countering this trend was an abrupt turnaround in nondefense discretionary outlays. By 1983, these programs were reduced to the place they had occupied relative to GNP in the early 1960s, before the growth of the Great Society programs. Caps on federal pay increases and a cessation of growth in grants to state and local governments contributed to the relative reduction in this category.

Baseline Projections, 1984-1988. Some of the recent trends are likely to continue in coming years, but others are not. CBO's baseline projections, which assume no further policy changes, imply that:

- National defense expenditures will continue to grow more rapidly than the rest of the budget and will constitute almost one-third of outlays by 1988.

- The extraordinary growth of net interest outlays will slow as the projected decline in interest rates offsets the projected rapid growth in debt outstanding. Nonetheless, at almost 12 percent of total outlays, interest payments will continue to be a major portion of federal spending.

- Entitlement spending in the aggregate will fall in relation to GNP (and as a share of total spending). In large measure, this decline reflects projected decreases in recession-related spending (unemployment compensation and farm price supports) and cuts in means-tested programs resulting from recent legislation. Spending on Medicare and Medicaid is projected to grow sharply as health-care prices continue to rise faster than prices in general. Social Security outlays should grow somewhat more slowly than GNP.

- Nondefense discretionary outlays are projected to become an ever-decreasing share of the total budget.

In dollar terms, these projections add $345 billion to federal outlays between 1983 and 1988. As the table on the following page shows, more than three-fourths of the projected outlay increase will be in the national defense and entitlements categories. Thus, any attempt to reduce outlays significantly as a major part of a $100 billion to $200 billion deficit reduction program will inevitably involve lower growth of spending in these two categories.

Change in Outlays, 1983-1988

	Billions of Dollars	Percent of Total
National Defense	144	42
Entitlements	125	36
Social Security	(64)	(18)
Medicare and Medicaid	(67)	(19)
Other	(-6)	(-2)
Nondefense Discretionary	39	11
Net Interest	47	14
Offsetting Receipts	-10	-3
Total	345	100

Approximately half of the projected $345 billion growth in federal spending represents inflation adjustments, not real growth. For nondefense discretionary programs, no real growth at all is assumed. [4] In entitlement programs, real growth is assumed to occur only to the extent that current laws permit increases in the numbers of beneficiaries or in the use of services. In national defense programs, however, real growth is a major part of the $145 billion increase. These baseline defense projections, moreover, are based on targets in the budget resolution passed in 1982; the Administration's January 1983 budget proposal exceeds these targets.

Federal Revenues, 1965-1981. Two major trends are evident in the history of federal revenues between 1965 and 1981. First, social insurance (mainly Social Security payroll) taxes and corporate income taxes combined accounted for a remarkably stable share of all federal revenues, but payroll tax revenues rose sharply while corporate taxes fell (see Table I-6). These trends were attributable primarily to a declining share of corporate profits in national income, to legislated reductions in corporate taxes, and to a sharply increased fraction of wages and salaries subject to tax along with higher payroll tax rates. The rise in payroll taxes reflects the increases in Social Security and Medicare spending noted previously. Second, repeated cuts in individual income taxes held them below 9 percent of GNP except in 1969-1970, when an income tax surcharge was in effect, and again in 1980-1981. The 10 percent of GNP that went for individual income taxes in 1981 was the highest share since World War II. This record 1981 tax burden is

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4. The basis for these projections assumptions is explained in CBO, Baseline Budget Projections for Fiscal Years 1984-1988.

TABLE I-6. FEDERAL REVENUES BY SOURCE, 1965-1981

Source	1965	1970	1975	1980	1981
			As a Percent of GNP		
Individual Income Taxes	7.4	9.3	8.3	9.5	10.0
Corporate Income Taxes	3.9	3.4	2.7	2.5	2.1
Social Insurance Taxes	3.4	4.6	5.7	6.1	6.4
Excise Taxes	2.2	1.6	1.1	0.9	1.4
All Other	0.9	1.0	1.0	1.0	1.0
Total	17.7	19.9	18.9	20.1	20.9
			As a Percent of Total Revenues		
Individual Income Taxes	41.8	46.9	43.9	47.2	47.7
Corporate Income Taxes	21.8	17.0	14.6	12.5	10.2
Social Insurance Taxes	19.1	23.0	30.3	30.5	30.5
Excise Taxes	12.5	8.1	5.9	4.7	6.8
All Other	4.9	4.9	5.4	5.0	4.8
Total	100.0	100.0	100.0	100.0	100.0

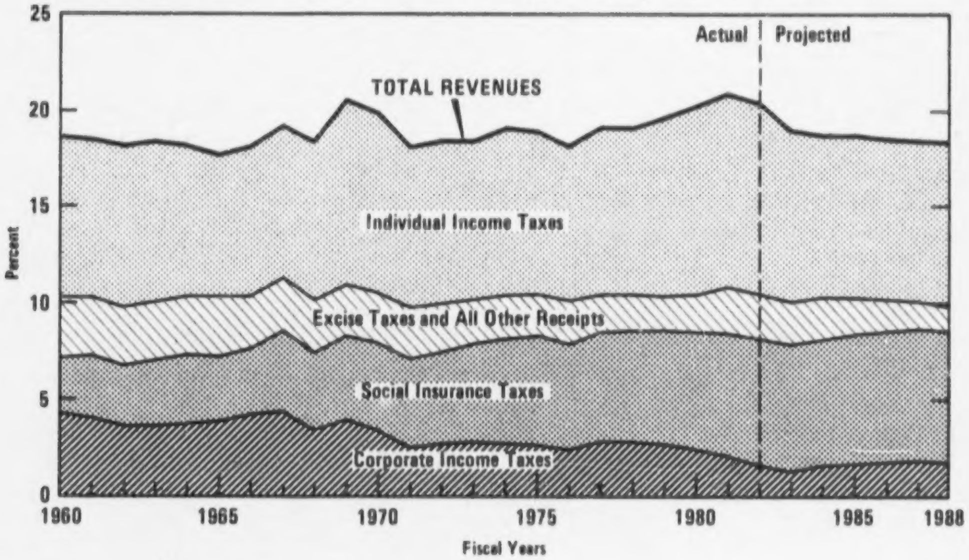
NOTE: Details may not add to totals because of rounding.

the major reason why total taxes as a share of GNP were 21 percent, the highest level in 35 years (see Figure I-5).

Federal Revenues, 1981-1988. In the 1981-1988 period, federal revenue projections show essentially a restoration of the tax burden that prevailed in the early 1970s (see Table I-7). Total revenues fall from 21 percent of GNP to nearly 18 percent. Payroll taxes continue to rise in importance, while excise and "all other" (customs duties and miscellaneous receipts) decline in importance. Most of the decline in the share of taxes in GNP is due to the fall in the ratio of personal income tax to GNP. This tax is projected to fall to 8.3 percent of GNP by 1988, the level it reached in the early 1970s.

Figure I-5.

Total Revenues as a Percent of GNP by Source, 1960-1988



The sharp reduction of the income tax burden in coming years is the result of the Economic Recovery Tax Act of 1981 (ERTA), which will reduce revenues by 1988, for example, by 5.6 percent of projected GNP (see Table I-7). Only a small fraction of the revenue loss under ERTA has been offset by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), which concentrated most of its revenue gains in the corporate tax sector.

Accordingly, the baseline projections show what might be termed a 1975-style total tax take matched against a 1988 outlay projection featuring much higher spending for national defense, entitlement programs, and net interest. Had the tax legislation of 1981 and 1982 not been enacted (all else being equal), a large fraction of the projected deficits would not have appeared. But that would have required taxpayers to shoulder a tax load of nearly 23 percent of GNP, much more than in any postwar year.

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TABLE I-7. FEDERAL REVENUES BY SOURCE, 1982-1988

Source	1982	1983	1984	1985	1986	1987	1988
				As a Percent of GNP			
Individual Income Taxes	9.8	8.9	8.4	8.4	8.3	8.3	8.3
Corporate Income Taxes	1.6	1.3	1.6	1.7	1.8	1.9	1.8
Social Insurance Taxes	6.6	6.6	6.6	6.8	6.8	6.8	6.8
Excise Taxes	1.2	1.2	1.2	1.1	0.9	0.8	0.7
All Other	1.1	1.0	0.9	0.8	0.6	0.6	0.6
Total	20.4	19.0	18.7	18.7	18.5	18.4	18.3
				As a Percent of Total Revenues			
Individual Income Taxes	48.3	47.2	45.1	44.9	45.0	45.2	45.5
Corporate Income Taxes	8.0	6.6	8.5	9.1	9.6	10.1	10.0
Social Insurance Taxes	32.6	35.0	35.5	36.1	36.9	36.9	37.1
Excise Taxes	5.9	6.2	6.4	5.8	4.7	4.3	4.1
All Other	5.3	5.0	4.5	4.1	3.8	3.5	3.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
MEMO: EFFECTS OF LEGISLATION							
				As a Percent of GNP			
ERTA	-1.3	-2.6	-3.9	-4.4	-5.0	-5.3	-5.6
TEFRA		0.6	1.0	1.1	1.1	1.2	1.2

NOTE: Details may not add to totals because of rounding.

ALTERNATIVE DEFICIT REDUCTION STRATEGIES

In developing a strategy for a major deficit reduction program, two general guidelines may prove helpful.

Policy Guidelines

First, sensible policy actions require a multi-year budget plan to be carried out over perhaps five years. The deficits projected for 1983 and 1984, as noted earlier, primarily reflect a sharply depressed economy.

Budget tightening for the short run could jeopardize the projected recovery. Moreover, much federal expenditure for the near term is fixed either by contract or by tacit commitment. Changing those expenditures would not only be disruptive; in many instances, it would raise, rather than lower, federal costs. For these reasons, the primary focus for deficit reduction initiatives should be on the latter part of the projection period.

Second, legislation should be enacted in 1983 to achieve a major part of the desired reduction in the deficit throughout the 1984-1988 period. Delays in correcting the structural deficit problem can contribute to uncertainty about the future of the economy, and such uncertainty can make lenders reluctant to enter into longer-term commitments. Moreover, budget changes are required this year to have even a moderate effect in later years. For example, because defense appropriations, especially for procurement of major weapons systems, spend out slowly, reductions in defense appropriations would be necessary this year in order to generate outlay savings in 1985 through 1988. Similarly, changes in the inflation adjustment provisions in Social Security and other benefit programs have cumulative effects--that is, the savings would be small at first, but later in the projection period, they would grow rapidly. Also, the longer time given for people to adjust to budgetary and tax changes, the smoother and more efficient the adjustments. Finally, enacting measures to reduce the deficit would be politically difficult in any year, but it will be especially so in the 1984 election year.

Broad Priorities Choices

In light of the need for a phased in deficit reduction program, three broad policy choices must be made.

An approximate deficit target for 1988 must be established. As noted earlier in this chapter, deficit goals ranging from 3 percent to 1 percent of GNP can be rationalized. But the choice really comes down to a matter of how high a priority is assigned to raising the prospects for capital investment in the economy. The more deficits are narrowed over the long term, the better the chances of a high-investment, low-interest-rate economy. Excessive or hasty measures to narrow deficits, however, can incur great risk of choking off a recovery, and of course, involve forgoing more government services or imposing greater burdens on taxpayers.

Whether to cut spending or raise taxes is the second choice that must be addressed once a deficit goal is established. Besides burdening taxpayers, all taxes impose efficiency costs on the economy. Higher income and payroll taxes almost surely discourage work effort and saving to some extent, and excise taxes distort economic choices. Though all these effects are negative, the spending cut alternatives also exact a price. The nation's economic strength and well-being depend on such investments as the the roads, scholarships, air traffic control, and medical research that federal money buys. Among the nation's most fundamental commitments is adequate care for its elderly and poor. Its security rests on maintaining an adequate national defense. Clearly, a rational resolution of how much to raise taxes and how much to cut spending must rest on an assessment of which of the negative consequences of either route seem less damaging.

The composition of outlay reductions or tax increases represents a third major policy choice. Because of their size, and projected growth, three major federal spending programs--national defense, Social Security, and Medicare--are necessary targets in any deficit reduction plan emphasizing outlay restraint. If revenues are not to be raised enough to narrow the budget deficits, the difficult choice between "guns versus butter" becomes inevitable. But raising taxes entails its own delicate balance of equity versus efficiency objectives.

Illustrative Examples

The magnitude of projected deficits means that marginal tinkering with the budget cannot yield adequate savings. To illustrate the kinds of broad strategies needed to reorient the federal budget, three policy examples are considered in this section. For simplicity and to give the examples a common basis of comparison, each illustration assumes that the goal for 1988 is to reduce the deficit to 2 percent of GNP (about $100 billion) from its projected baseline level of 5.6 percent of GNP ($267 billion) in that year. In keeping with the discussion above, all options assume that budget reduction measures are phased in, with revenues increasing only in fiscal year 1985 and spending reductions held under 1 percent of GNP (about $35 billion) in 1984.

Example 1--Raising Revenues to Pay for Defense Growth. This approach illustrates the implications of closing most of the budget gap by means of tax increases; it would raise taxes to 21 percent of GNP by 1988--the postwar high level last seen in 1981. It is further assumed that national defense outlays would grow unchanged from the CBO baseline.[5] From a cumulative five-year budget gap that would exceed $1,100 billion under the CBO baseline, this option would produce budgetary savings of about $450 billion (see Figure I-6). Of this total, about 70 percent would be derived from higher revenues and the remaining sum from outlay savings.

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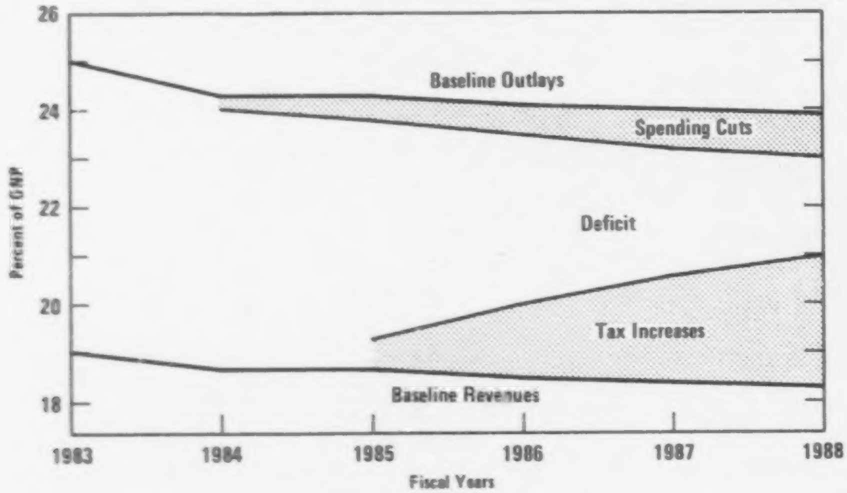
[5] It should be noted that the Administration's defense proposal is in excess of the CBO baseline.

Figure I-6.

Strategy Example 1—Restore Tax Share to 1981 Level, Maintain Baseline Projection for Defense



Cumulative Savings 1984-1988

(Billions of dollars)

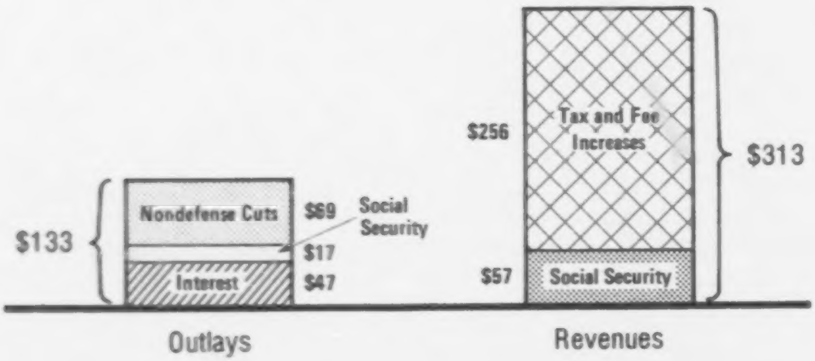
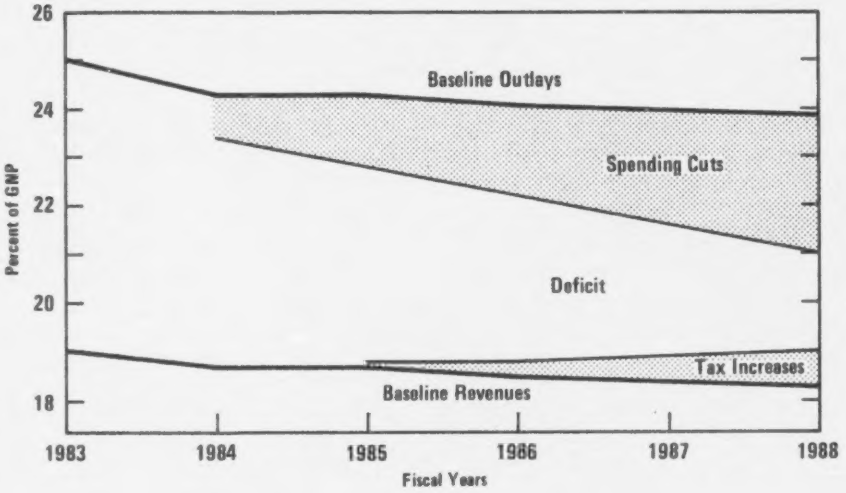


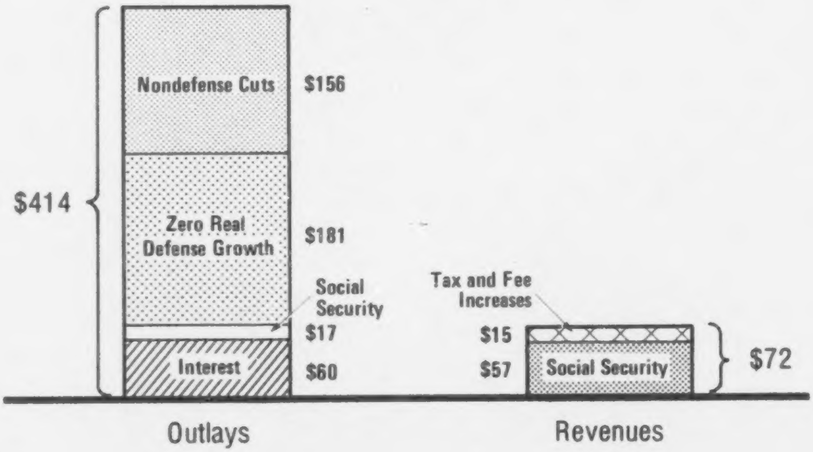
Figure I-7.

Strategy Example 2—Freeze Tax Share at 1983 Level, Cut Government Spending



Cumulative Savings 1984-1988

(Billions of dollars)



If one assumes that the recently submitted proposals of the National Commission on Social Security Reform are adopted (see Chapter III) and further, that budgetary savings are phased in so that interest costs over five years would be reduced by almost $50 billion from the CBO baseline, the implications of this strategy are as follows.

More than $250 billion in new taxes (aside from the Social Security commission proposals) over the next five years would have to be raised. A revenue goal of this magnitude could be met by repealing both the indexing of the individual income tax and the third-year tax cut enacted under ERTA. Measures that could either be alternatives to these or in some way combined with them include major base-broadening tax reform or instituting some new revenue measure such as a value-added tax (see Chapter X). At the same time, about $70 billion in outlay savings would be required during the five-year period over and above the Social Security commission proposals and interest savings Given the maintenance of national defense growth implied in the CBO baseline, these savings would have to come from entitlement and nondefense programs. If all appropriated nondefense programs were frozen at 1983 levels, five-year outlay savings would be about $50 billion (see Chapter VII).

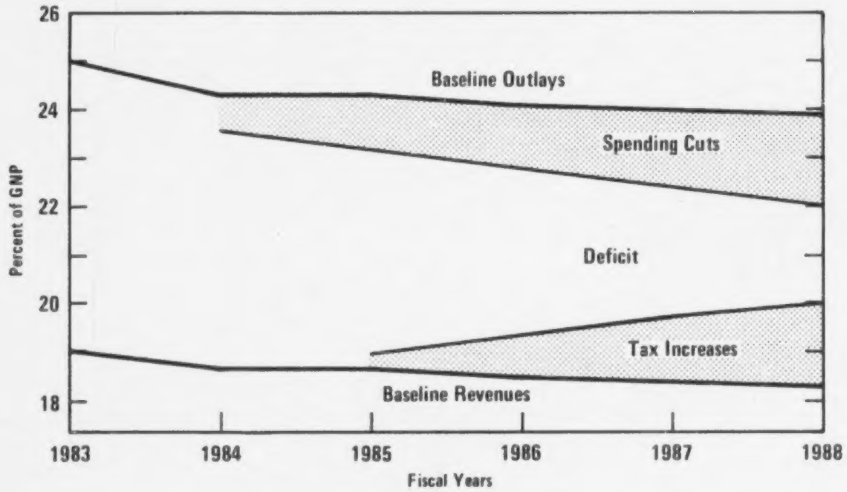
Example 2--Cutting Government Spending. This approach would emphasize cutting federal spending and allowing the tax burden to rise no higher than 19 percent of GNP, the level projected for 1983. Under this alternative, nearly $500 billion in cumulative deficit reduction would be realized by about $70 billion in higher revenues and more than $400 billion in outlay savings (see Figure I-7).

Achieving a five-year plan to curb outlays by more than $400 billion would necessitate major cuts not only in the defense budget, but in nondefense programs as well. Even if the real growth rate of national defense appropriations were held to zero, outlay savings from the CBO baseline would amount to about $180 billion over the 1984-1988 period. This means that spending cuts in nondefense programs would have to come to about $150 billion (assuming again that the Social Security commission's proposals and interest savings were realized). If all appropriated nondefense programs were frozen at the 1983 level, and if Medicare patients' copayments for hospital charges were raised, and if veterans' compensation payments were reduced, aggregate five-year savings would only be about $80 billion. So the domestic cuts would have to go even deeper. Thus, to hold the tax burden at this year's level, even a major reversal of defense growth would still imply substantial further nondefense cuts.

Example 3--An Intermediate Strategy. This approach would strike a balance between the extremes of the tax increase and defense spending

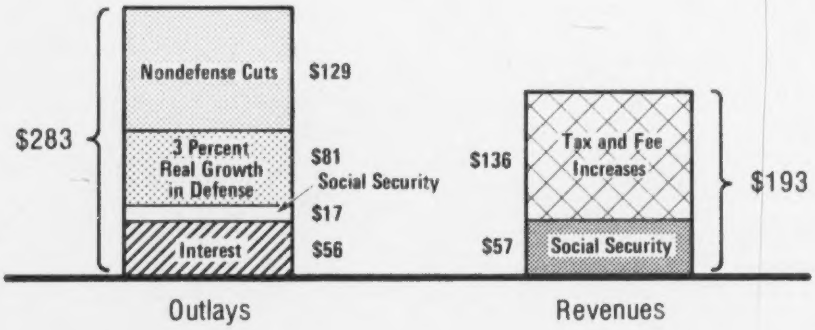
Figure I-8.

Strategy Example 3—Raise Tax Share to Intermediate Level, Limit Defense to 3 Percent Real Growth



Cumulative Savings 1984-1988

(Billions of dollars)



patterns under the other two examples. To do so, it would set an intermediate tax target of 20 percent of GNP by 1988 and cut defense appropriations back to 3 percent real growth. This option would require outlays to fall to 22 percent of GNP of 1988, and would shift the division of cumulative deficit reductions to about 60 percent from outlays and 40 percent from revenues (see Figure I-8).

The revenue increase target of nearly $200 billion over five years required to meet this goal is attainable under a number of options that are often discussed. For example, repeal of the indexation of individual income taxes scheduled to take effect in 1985 would save $90 billion over the projection period. Repeal of half of the third stage of the ERTA individual tax cut would yield about $90 billion. And implementation of the Social Security commission's proposals would yield another $57 billion. Many other choices are discussed in Chapter X.

Meeting a goal of about $280 billion in outlay savings over the five-year period would allow some, but limited, flexibility as to where spending cuts could be made. Setting aside the $17 billion in the Social Security commission's proposed savings and the $56 billion in reduced interest would leave about $200 billion in needed savings from all other spending programs. As an illustration, this sum could be composed of $81 billion from defense spending (held at 3 percent real growth), $88 billion from a 2 percent cut in nondefense discretionary spending, and the remainder from other nondefense sources.

Perhaps the main lesson in these illustrations is that, without a substantial contribution from increased taxes and reduced spending from all major programs, it is very hard to devise a deficit reduction package that is realistic or sensible. The examples outlined above represent three quite different courses for narrowing the budget deficit under a common reduction goal. However strict an objective the Congress sets for reducing the deficit will determine the difficulty of this pressing task. Certainly, though, any major proposals to increase spending, such as the Administration's planned defense efforts (see Chapter II), would necessitate greater cuts in other spending programs and greater increases in taxes if a particular deficit reduction objective were to be met. Even with a commitment to a balanced approach with no sectors immune, many difficult choices would confront the Congress.

ON USING THIS VOLUME

The remainder of this volume presents a wide array of budgetary elements that could be combined in various strategies to narrow the deficit.

Chapters II-IX are organized according to the budget categories identified earlier in this chapter. Each chapter presents major arguments for and against a number of deficit reduction measures within that budget category that have been proposed or might be considered in the future. The "budget savings" of each proposal are measured in terms of outlay reductions or revenue increases from the CBO baseline just described. Unless otherwise noted, the estimates assume that a proposal is fully implemented by the start of fiscal year 1984, under baseline economic assumptions. The chapters also report "cumulative five-year savings," which simply represent the sum of savings in each of the fiscal years 1984-1988. Similarly, Chapter X presents options for raising revenues above the baseline projections. Appendix A contains brief descriptions of 28 revenue-increasing options referred to in Chapter X but not analyzed in the chapter. Appendix B provides a crosswalk to distribute the spending and revenue options discussed in this volume by functional categories used in the budget resolution. The tables in this appendix include page references to the chapter discussion of the various options, and thus they also serve as an index to the volume.

Three cautions must be noted at the outset. First, the deficit reductions discussed in this volume represent only a first approximation of savings that might actually be realized. In some instances, a reduction in one program might result in program expansion elsewhere. Reducing Social Security benefits, for example, would generally increase payments from other programs such as Supplemental Security Income and Food Stamps. In most cases, unless otherwise specified, these offsetting effects are not included in the estimates presented in this report.

Second, any enduring reduction in outlays or increase in revenues will ultimately result in a lower public debt, and therefore in lower net interest outlays than would otherwise be the case. Thus, an annual savings of $4 billion in a program would reduce the projected public debt outstanding by $20 billion in five years and--at a 5 percent interest rate--would lower annual net interest outlays by $1 billion. Obviously, one cannot attribute such savings to particular deficit reduction measures, but only to a whole package of changes. Therefore, the options in the chapters that follow do not include the induced interest savings.

Finally, the relation of the underlying economic assumptions and changes in budget policy needs to be understood. The economic assumptions for the outyears of the CBO baseline budget projections represent a plausible path for the economy to take. These assumptions are consistent with a variety of fiscal policies. If a policy change from the baseline budget were undertaken, it should not be presumed that such a change would necessarily affect the economic assumptions used in the baseline. On the other hand, a major budget change might warrant revisions of the assumed economic path. In 1982, for example, when the First Concurrent Resolution on the Budget for Fiscal Year 1983 was under consideration, the supporters of deficit reduction (mainly through a tax increase) argued that such a change would work to reduce interest rates below those that were assumed in the baseline then being used. On the basis of these lower interest rates, they further adjusted the budgets projected in the budget resolution. In this report, all deficit reduction options are estimated under the CBO baseline economic assumptions without any feedback effects.

CHAPTER II. NATIONAL DEFENSE

Defense budget authority has grown rapidly in real terms in recent years and is scheduled for further increases in Administration plans for fiscal year 1984 and beyond. In 1984, it represents 29 percent of Administration spending plans, second only to direct payments to individuals at 42 percent. Defense spending will undoubtedly be a major focus this year, as last, of any Congressional effort to reduce the level of budget deficits. While last year the Congress cut the Administration's defense budget request, it still provided about 7 percent real growth in budget authority over the previous year.

The national defense portion of the budget provides funding for the operations of existing armed forces and the purchase of new equipment and facilities to improve and expand the capabilities of those forces. Department of Defense (DoD) spending makes up the bulk of national defense funding. Nuclear weapons programs funded through the Department of Energy are included in national defense, but are not analyzed in this chapter. Other expenditures that are arguably part of the costs of defense, though not included in this chapter, are veterans' benefits (see Chapter V); most of the costs of retirement for Defense Department civilians (see Chapter VIII); and tax expenditures such as tax-free military allowances for housing (see Chapter X).

Over half of total DoD budget authority for 1983 provides compensation for military and civilian personnel (including military retirement), and for the operations and maintenance of existing equipment and facilities (see Figure II-1). These operating accounts fund pay and allowances, combat training and exercises, maintenance and repair activities at extensive DoD-owned and commercial industrial facilities, and operations at more than 5,000 installations and properties in the United States and overseas. The remaining budget authority--generally called the investment accounts--pays for ongoing research, development and production of new equipment, and construction of new facilities. Procurement of new combat and support equipment is by far the largest category, projected at 35 percent of total 1983 budget authority.

Figure II-1 also shows DoD budget authority by mission activities, using standard DoD definitions. Each of these activities requires funding for operations and maintenance, and pay for the military and civilian personnel assigned to the activity. To a varying degree, each mission activity also

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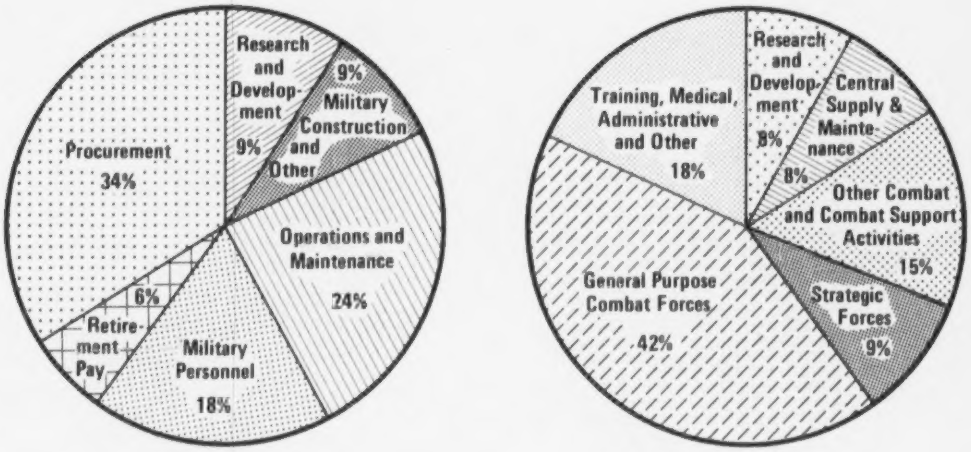
Figure II-1.
Fiscal Year 1983 Defense Budget (Budget Authority)



By
Appropriation Account

By
Military Mission

requires procurement, military construction, and research and development (R&D) funding. Strategic forces, while prominent in the defense debate, require a relatively small portion (9 percent) of total defense budget authority, though that portion is highly concentrated in investment accounts. General-purpose forces and other combat-related activities (such as communications and intelligence, Reserve and National Guard forces, and mobility forces) will receive 55 percent of DoD funds in 1983. Support activities--such as central logistics support and basic training--require the remaining 35 percent.

BUDGET HISTORY AND PROJECTIONS

Recent History, 1980-1982

The Administration has made higher defense spending a primary objective, and to date the Congress has generally endorsed this. Defense outlays have increased from $136 billion in 1980 to $187 billion in 1982, an increase of 38 percent (12 percent in real terms--that is, excluding inflation). Budget authority--a better measure of the commitments assumed through the defense buildup--has increased 50 percent (25 percent in real

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terms) in just three years. Budget authority entails the legal right to make spending commitments. Actual defense expenditures, called outlays, often lag budget authority by several years because of the time needed to build weapons.

Investment in new equipment has received primary emphasis, while other categories of defense spending have also increased; budget authority for procurement has increased 85 percent since 1980 (60 percent in real terms). All types of military equipment are being purchased, though particular emphasis is given to modernizing strategic forces (the B-1 bomber, the advance technology "stealth" bomber, cruise missiles, the Trident II missile, the MX missile) and expanding the size of the Navy. Operating accounts have increased by 36 percent since 1980 (12 percent in real terms).

The Current Situation

The President requested budget authority of $263 billion and outlays of $221 billion for national defense in 1983. Excluding inflation, this would amount to an increase of 15 percent in budget authority and 13 percent in outlays over 1982. Rather than pass a defense appropriation in the usual manner (except for military construction), the Congress enacted the 1983 defense budget as part of a continuing resolution that will remain in force for the remainder of the fiscal year. This continuing resolution, containing the program details of a normal appropriation bill, cut budget authority for 1983 by $19 billion below the President's request, limiting real growth to about 7 percent.

Baseline Projections, 1984-1988

This chapter adopts a different approach for baseline projections from that used in the other chapters. Instead of using CBO's baseline projections, this chapter uses the Administration's announced spending targets as the base for discussing reductions in the defense budget. The Congress has generally selected Administration defense spending plans as the basis for establishing budget resolutions. However, both spending paths will likely enter the defense debate in coming months. As such, the annual budget authority and outlay figures for both baselines are shown in Tables II-1, II-2, and II-3 below. The program cuts (Table II-4) discussed below should be subtracted only from the Administration targets (Table II-3), since the program cuts are more consistent with the proposed budget than with Administration plans submitted last year, which is the basis for the CBO baseline.

TABLE II-1. ALTERNATIVE LEVELS OF DEFENSE SPENDING (In billions of dollars)

	Actual		Estimated	Baseline Projection				
Spending Level	1980	1982	1983	1984	1985	1986	1987	1988
CBO Baseline--1983 Budget Resolution Extended a/								
Budget Authority	182	219	244	278	322	350	373	398
Outlays	160	187	213	242	278	310	333	358
Administration's Request								
Budget Authority	182	219	245	281	330	365	397	433
Outlays	160	187	215	245	285	323	354	386

a. The fiscal year 1983 budget resolution covered only the years 1983-1985. The resolution figures for 1984 and 1985 are shown here. Spending beyond 1985 was estimated by lowering previous Administration growth targets by 2 percentage points. That reduction was the average real growth cut imposed by the budget resolution relative to Administration spending plans for the 1983-1985 period.

The CBO Baseline. The CBO baseline for defense spending is built on the fiscal year 1983 budget resolution. The projections for 1984 and 1985 are the budget authority and outlay figures specified in the resolution adopted last year. Beyond 1985, the CBO baseline reduces the annual real rate of growth assumed in the Administration's fiscal year 1983 budget request by two percentage points, which is consistent with the resolution. Whereas the Administration had planned an average of about 9 percent real growth (1983-1985), the 1983 budget resolution provided an average of slightly more than 7 percent for the same period, over two percentage points less than the President's request. This spending path would provide defense budget authority of $278 billion and outlays of $242 billion for 1984, with the complete spending path shown in Tables II-1 and II-2.

The primary value of this baseline is to present five-year budget authority and outlay targets consistent with the budget compromises and decisions reached last year by the 97th Congress. The President indicated during a press conference in August 1982, however, that he did not feel

TABLE II-2. SAVINGS UNDER ALTERNATIVE SPENDING ASSUMPTIONS RELATIVE TO CBO BASELINE (In billions of dollars)

Spending Level	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
CBO Baseline--1983 Budget Resolution Extended						
Budget Authority	278	322	350	373	398	
Outlays	242	278	310	333	358	
Savings Under Alternative Assumptions						
5 Percent Real Growth						
Budget Authority	11	23	18	4	-12	44
Outlays	2	10	12	2	-6	20
3 Percent Real Growth						
Budget Authority	16	34	37	31	25	143
Outlays	4	16	23	19	19	81
Zero Real Growth						
Budget Authority	20	49	62	69	76	276
Outlays	8	27	43	48	55	181

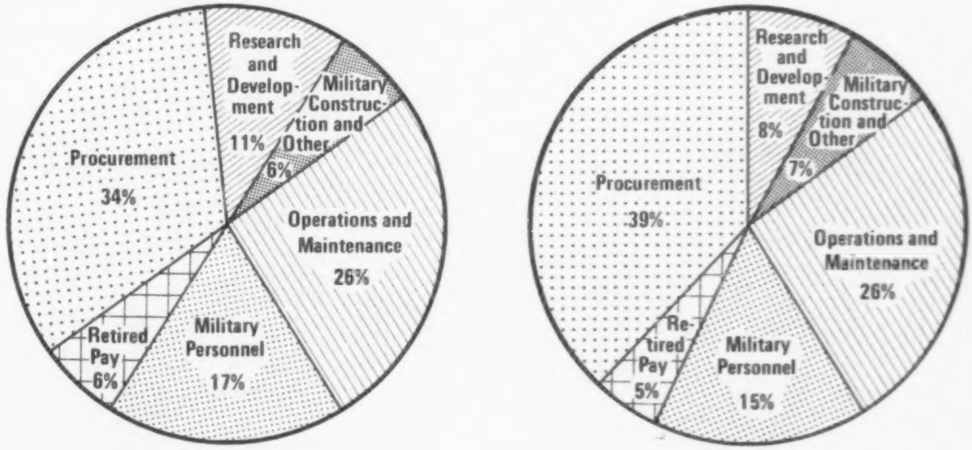
NOTE: Program cuts and projected savings discussed below and shown in Table II-4 should not be deducted from baseline projections shown on this table, but from those projections shown on Table II-3. The CBO baseline, which is based on the 1983 budget resolution, is built on the program details submitted with last year's budget. The program cuts discussed in this chapter are more consistent with current Administration spending plans.

obligated to follow the defense spending targets set in the 1983 budget resolution for 1984 and beyond, but rather only to follow total spending levels of the resolution.

The Administration's Defense Request. The Administration's 1984 budget proposal for defense would require budget authority of $281 billion and $245 billion in outlays for 1984, with continuing increases thereafter, as shown in Table II-1. While close to the CBO baseline in 1984, the Administration proposes substantially higher outyear levels than the Congress intended last year, some $85 billion more in budget authority over the five-year period (see Table II-3). This chapter uses these Administration targets as the base against which savings from options to lower defense spending are measured. It adopts this higher spending path as the base because the Congress will likely use the Administration's request as the basis for its deliberations over the 1984 budget resolution. Further, DoD's detailed plans for weapons purchases--which are the primary basis for this chapter's discussion of targeted reductions--are most consistent with these Administration spending targets. Figure II-2 compares, by appropriation account, budget authority in 1984 and 1988 for the Administration program. Administration plans continue to emphasize procurement, which would require 39 percent of total defense budget authority by 1988.

Figure II-2.

Defense Department Budget, Fiscal Years 1984 and 1988 (Budget Authority)



1984 1988

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DEFICIT REDUCTION STRATEGIES

The debate on the defense budget in the 97th Congress took place at two levels. At one level, the Congress broadly debated the extent of the resources that should be devoted to national security compared with other spending priorities of the federal government. At a more detailed level, it examined particular programs of the defense budget--for example, debating the need to buy two aircraft carriers in 1983. The remainder of this chapter parallels that debate. The following section identifies four possible overall levels of defense spending. The next section outlines several broad strategies for trimming the rate of growth in defense spending and then examines potential reductions in specific programs.

ALTERNATIVE SPENDING TARGETS

As in last year's budget review, debate in the opening months of the 98th Congress will focus on aggregate levels of resources devoted to various national priorities, including defense. On one hand, the Congress can choose to accept the Administration's budget targets, which are used as the basis for projected spending and savings in this chapter. With those targets, budget authority would grow from $244 billion in 1983 to $281 billion in 1984 and to $433 billion by 1988 (see Table II-3). This implies annual real growth of 6.5 percent a year in 1984-1988. Over the 1981-1988 period, annual real growth would average about 8 percent.

Alternatively, the Congress can cut the Administration's defense request to the levels that the 1983 budget resolution set for 1984 and 1985, and continue with lower rates of growth than planned by the Administration for the years beyond 1985. This would reduce budget authority and outlays by $3 billion in 1984, with projected five-year savings shown in Table II-3. 1/ With these reductions, real growth in the defense budget in 1984-1988 would average about 4.5 percent a year. For 1981-1988, defense budget authority would grow at an average 6 percent a year in real terms.

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1. Real growth implied by the Administration's 1983-1985 program averaged 9 percent. The 1983 budget resolution provided an average annual real growth of 7 percent. For purposes of projecting a five-year profile, the Administration's real growth targets beyond 1985 were reduced by two percentage points and applied to the lower base of 1985 budget authority stipulated in the 1983 budget resolution.

TABLE II-3. SAVINGS UNDER ALTERNATIVE SPENDING ASSUMPTIONS RELATIVE TO ADMINISTRATION REQUEST (In billions of dollars)

Spending Level	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Administration's Request						
Budget Authority	281	330	365	397	433	
Outlays	245	285	323	354	386	
Savings Under Alternative Assumptions						
CBO Baseline--1983 Budget Resolution Extended						
Budget Authority	3	8	15	24	35	85
Outlays	3	7	13	21	28	72
5 Percent Real Growth						
Budget Authority	14	31	33	28	23	129
Outlays	5	17	25	23	22	92
3 Percent Real Growth						
Budget Authority	19	42	52	55	60	228
Outlays	7	23	36	40	47	153
Zero Real Growth						
Budget Authority	23	57	77	93	111	361
Outlays	11	34	56	69	83	253

Should the Congress wish to make even greater reductions, it could further limit the increase in defense budget authority. Table II-3 shows the savings possible if defense increases over inflation were limited to 5 percent and 3 percent, respectively, in 1984-1988 in terms of budget authority. Either growth path would be substantially lower than Administration proposals, although both would be imposed upon real increases of about 30 percent in defense budget authority adopted since 1980. Even at the lowest rate of real growth shown here--3 percent annual average over the next five years--growth in defense budget authority in 1981-1988 would still exceed 5 percent a year because of the large increases adopted in 1981 and 1982.

In recent weeks, several more radical approaches for reducing budget deficits have been suggested, including proposals to "freeze" federal spending. Table II-3 shows the savings implied by a zero real growth alternative; it shows budget authority in this 1984-1988 period adjusted only to reflect inflation over the 1983 level. Several of the proposals have called for freezing outlays, since outlays constitute budget deficits. Freezing defense outlays relative to 1983 would be extraordinarily difficult, however, since a major portion of 1984 outlays (about 35 percent) reflect spending commitments made in 1983 and even earlier. Were budget authority frozen, outlays in 1984 would still increase $14 billion over 1983 because of prior year commitments. Far more radical cuts than suggested in this chapter would be needed to meet the spending levels implied in a zero real growth alternative.

TARGETED REDUCTION STRATEGIES

Adopting strategies to meet lower levels of defense spending requires making difficult judgments about the adequacy of existing forces as well as the scope and urgency of defense requirements. Moreover, alternative reduction strategies may have significantly different effects in the timing of their savings, as well as in their impact on combat effectiveness or military readiness. For example, a reduction strategy emphasizing cuts in operating accounts--such as training activity or ship steaming hours--would offer significant near-term savings, since the bulk of operating funds authorized in a fiscal year will be spent in that fiscal year. Such cuts, however, would directly affect near-term combat readiness. Also, since the savings might not carry over to subsequent years, additional cuts in readiness might be needed to meet future lower spending targets.

Budget authority cuts in procurement accounts, on the other hand, would offer relatively small near-term savings in outlays, but these savings would stretch out over several years. Cutting a $3.5 billion aircraft carrier, for example, would save only $85 million in the first year, since only limited

TABLE II-4. BUDGET SAVINGS FROM ALTERNATIVE APPROACHES TO DECREASING DEFENSE EXPENDITURES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Lower Growth in Procurement Accounts						
Cancel the F/A-18, Buy A-6Es						
Budget Authority	-0.2	0.7	1.6	2.1	4.1	8.4
Outlays	a/	a/	0.4	1.2	1.9	3.5
Cancel the DIVAD						
Budget Authority	0.9	0.8	0.7	0.4	--	2.8
Outlays	0.1	0.5	0.7	0.7	0.5	2.4
Cancel the AHIP b/						
Budget Authority	0.2	0.3	0.3	0.5	0.5	1.8
Outlays	a/	0.1	0.2	0.3	0.4	1.0
Cancel MX, Rely on Trident II						
Budget Authority	8.2	7.0	5.4	4.0	3.2	27.8
Outlays	3.0	5.6	5.7	4.9	4.0	23.2
Scale Back Purchases of F-15s						
Budget Authority	0.7	1.6	2.4	2.6	2.7	9.9
Outlays	0.1	0.5	1.2	1.9	2.3	5.9
Limit Tanker Re-engining c/						
Budget Authority	0.5	0.3	0.3	0.1	a/	1.2
Outlays	0.1	0.3	0.3	0.3	0.2	1.1
Cancel DDG-51 Program						
Budget Authority	0.1	0.2	0.4	1.9	3.5	6.2
Outlays	a/	a/	0.1	0.2	0.5	0.8
Cancel C-17 Program						
Budget Authority	a/	a/	0.2	1.2	2.1	3.5
Outlays	a/	a/	0.1	0.4	0.9	1.5

(Continued)

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a. Savings less than $50 million.

b. The Army has indicated that modest cancellation penalities maybe required. This has not been deducted from the above savings.

c. Program detail for fiscal year 1984 of the Administration's budget was the only data available at time of publication. No outyear information was provided. Preliminary data suggest the savings shown are overstated, at least for 1984, though lack of substantive detail prevents formal estimates.

TABLE II-4. (Continued)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Impose Modest Force Structure Cuts/Boost Contributions of Allies						
Deactivate One Army Division						
Budget Authority	0.2	0.4	0.6	0.6	0.6	2.4
Outlays	0.2	0.4	0.5	0.6	0.6	2.3
Boost Canadian Support of NORAD						
Budget Authority	a/	a/	a/	a/	a/	0.2
Outlays	a/	a/	a/	a/	a/	0.2
Press for Japanese Purchases of AWACS c/						
Budget Authority	0.2	0.5	0.6	0.2	-0.6	1.0
Outlays	a/	0.2	0.4	0.5	0.3	1.3
Limit Growth in Pay and Benefits						
Reflect Savings Created by Pay Freeze in 1984 d/						
Budget Authority	a/	2.0	1.7	1.7	1.7	7.0
Outlays	a/	1.9	1.7	1.7	1.7	7.0
Restructure Military Pay e/						
Budget Authority	a/	a/	0.3	0.6	0.9	1.9
Outlays	a/	a/	0.3	0.6	0.9	1.9
Limit Growth in O&M Accounts						
Budget Authority	0.7	1.5	2.6	3.8	5.1	13.7
Outlays	0.6	1.3	2.4	3.5	4.8	12.6
Total						
Budget Authority	11.5	15.3	16.8	15.5	22.9	85.9
Outlays	4.1	10.8	13.7	16.2	18.1	62.8

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d. The Administration provides no catchup raise to compensate for the 1984 freeze. They have programmed a "contingency" raise, which is shown here. These savings incorporate CBO's comparability assumptions.

e. These savings might be overstated since the Administration's budget already provides for permanent enactment of the half COLA provision, which constitutes the bulk of saving shown here. These savings are not included in the totals shown below.

work can be accomplished in the first year of funding and it takes eight years to build the carrier. By the same token, cuts in procurement accounts might have only a limited impact on near-term combat effectiveness but more significant longer-term effects. Since the savings in outlays stretch over several years, cutting procurement items would help meet future lower spending targets whereas cuts in one year's readiness activity (such as reduced flying hours for training) would not.

The Congress might adopt a number of strategies for lowering defense spending. These could include:

- Scaling back real growth in procurement accounts, by canceling programs experiencing development problems, by slowing the pace of modernization in selected areas, or by redirecting preliminary development efforts to emphasize less expensive longer-term systems;
- Imposing modest cuts in current force structure or buildup plans;
- Limiting growth in pay and benefits; and
- Limiting growth in operations and maintenance accounts.

The remainder of this chapter presents specific options for budget reductions, organized to follow these reduction strategies. The Administration's 1984-1988 program is the baseline used for the analysis. Not all program details had yet been presented to the Congress when this report was sent to the publisher. Specific program changes in the 1984 budget relative to last year's plans could alter this discussion. As such, some of the savings discussed below may be incorrect. 2/

Scale Back Real Growth in Procurement Programs

The Administration's primary emphasis in defense spending has been the purchase of new combat and support equipment. Budget authority for procurement is currently over a third of the defense budget and has

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2. Savings are limited to those costs directly tied to the primary decision. For example, savings from cutting MX would include savings in related military construction, support equipment, and initial spare parts. Unless otherwise indicated, there are no personnel savings included.

increased 85 percent since 1980. If the Administration's plans were carried out, budget authority for procurement in 1988 would be 382 percent greater (198 percent in real terms) than in 1980.

The Congress could direct a more moderate increase in the purchase of new combat systems. Such an alternative could take several distinct forms, including:

- Canceling selected weapons programs that are experiencing development problems or failing to meet program expectations;
- Continuing modernization programs, but at a slower pace;
- Redirecting preliminary development efforts to emphasize longer-term systems intended for the 1990s.

As noted above, cuts in procurement programs offer relatively small outlay savings in the first year of the cuts but much larger savings in future years, thereby easing the task of meeting lower future spending targets. Although such cuts do not immediately affect readiness, they may have a long-term impact on combat effectiveness.

Cancel the F/A-18, Buy A-6Es as Substitutes. The F/A-18 is a dual-purpose fighter and bomber, to be deployed with the Navy and the Marine Corps. It was originally intended to be a lower-cost (and less capable) complement to the more expensive and capable F-14 fighter/interceptor. The Navy expanded its mission, however, making the F/A-18 a primary light attack bomber designed to replace the A-7 currently in the inventory. The Navy now intends to buy the F/A-18 primarily as an attack bomber, with the F-14 being purchased as the Navy's fighter for the future. 3/

In the attack role, the F/A-18 would have some definite advantages over other attack planes the Navy could buy. It can fly at supersonic speeds and it would generally be able to carry as much or more ordnance at short ranges. It is designed to be more reliable, which could help hold down peacetime operating costs and improve wartime operations tempos. And it can be flown as a fighter; this dual-mission capability is something no alternative aircraft could offer.

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3. The Marine Corps will use the F/A-18 as a fighter, and the Navy will buy a small number to use as fighters on two older aircraft carriers physically incapable of operating the F-14.

Recent Navy evaluation tests found, however, that without further modification the F/A-18 could not perform important combat missions specified in Navy requirement documents. Earlier last year, the Secretary of the Navy had suggested terminating the F/A-18 program because of substantial increases in the cost of the aircraft, buying instead the Navy's most capable attack bomber, the A-6E, for all attack squadrons. The Secretary recently restated his support for the F/A-18, even though its costs beyond 1983 have not been reduced. Indeed, recent press reports suggest that last year's actions did not stem the cost rise of the F/A-18 and that further program cost increases may be expected. It is now substantially more expensive than the A-7 it is to replace, and might even be as expensive as the A-6E were the Navy to purchase the A-6E at economic rates. Unlike the F/A-18, the A-6E is an all-weather day-night attack bomber. The Navy is considering a program to upgrade the A-6E to a new F model, which would then be the premier bomber until the turn of the century. CBO analysis has shown that, in addition to the advantages of all-weather day-night operations, the A-6E can carry substantially more ordnance than the F/A-18, especially at long range. 4/

The Congress could reduce the cost of modernizing carrier-based aircraft by terminating the F/A-18 as an attack bomber and choosing the more capable A-6E, as previously suggested by the Secretary of the Navy. The Navy would continue to develop the A-6F as the improved attack bomber for the future. This alternative would not only enable purchase of a more capable bomber aircraft, but also would provide budget savings of $8.4 billion over the next five years (see Table II-4). These savings reflect a gradual phasing out of the F/A-18 program over four years. Those F/A-18 aircraft currently in the inventory, and those purchased during the wind-down stage, would serve as fighter aircraft for the Marine Corps; they would also provide fighters for two older aircraft carriers incapable of supporting the larger F-14. The savings shown in Table II-4 are net of the increased purchases of A-6Es. An additional advantage of this option is that, at higher production rates, the A-6E can be purchased at substantially lower unit costs, which would also help to hold down the cost of the new A-6F.

The five-year savings in Table II-4 are caused by purchasing fewer aircraft, and, as such, overstate the long-run savings. Because the F/A-18 program would be phased out more quickly than production of A-6Es could be increased, this alternative would buy 242 more A-6E/Fs than the Administration plans over the next five years, and 397 fewer F/A-18s. Buys

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4. See Congressional Budget Office, Costs of Expanding and Modernizing the Navy's Carrier-Based Air Forces (May 1982).

of A-6Es would have to continue in later years to make up this difference. Moreover, costs in Table II-4 reflect those for the A-6E, not those for an A-6F which could be more expensive.

Cancel the Division Air Defense Gun. The Army's Division Air Defense Gun (DIVAD) is primarily designed to attack enemy helicopters and low-altitude aircraft that are within four kilometers of the DIVAD. It is also capable of attacking lightly armored vehicles and trucks. Mounted on an M48A5 tank chasis, this twin 40mm gun system relies upon a sophisticated radar, similar to that on the F-16 aircraft. The system has a rapid-fire capability; after it identifies a target, DIVAD can position and fire its gun within ten seconds. The DIVAD will replace the existing Vulcan 20mm gun system. Vulcan has an effective range of two kilometers, and--because it lacks a sophisticated radar--has limited effectiveness in the inclement weather common in Europe.

Although the DIVAD offers significant improvements relative to the Vulcan air defense system, the latest version of the Soviet attack helicopter--the Hind E--reportedly has an effective range of eight kilometers, twice as great as that of the DIVAD gun. Were the Warsaw Pact to field the attack helicopters at rates consistent with recent historical experience, by the end of the decade almost 50 percent of the helicopter fleet could fire its ordnance beyond the range of DIVAD. Further, the active radar, which is critical to DIVAD's accuracy, could become vulnerable to Soviet missiles that "home in" on the radar beam, increasing DIVAD's vulnerability to enemy helicopters at extended ranges. Moreover, some have expressed concern that DIVAD's sophisticated radar would be difficult to maintain during ground combat.

Nonetheless, the Army plans to procure 472 DIVAD systems in 1984-1987, at a total program procurement unit cost of $6.5 million each. To date, the Army has been authorized to order 146 units.

The Congress could choose to cancel the DIVAD program, directing the Army to develop a system less vulnerable to countermeasures, and capable of defeating Soviet systems projected for the future. In the interim, the Army would rely on the existing Vulcan air defense gun, as well as already-planned buys of the Stinger air defense missile currently being deployed in the Army. The Stinger is a shoulder-fired missile that homes in on a heat source. Its primary mission is to attack low-altitude aircraft and helicopters.

Eliminating DIVAD would result in net savings of $934 million in 1984 and a total of $2.8 billion over the five years (see Table II-4).

Cancel the Army Helicopter Improvement Program. The Army Helicopter Improvement Program (AHIP) is designed to provide a more capable scout helicopter by the mid-1980s through modification of the existing OH-58 helicopter. Scout helicopters have no weapons; their primary mission is to acquire and designate targets for both the attack helicopters and the artillery. Relative to the current scout helicopter, the AHIP improves the acquisition of targets at nighttime and the operational capability of the helicopter in the Southwest Asia environment. 5/

While the modification program would enhance the OH-58 helicopter, the Army considers it only an interim solution for the scout mission. 6/ At present, the Army is developing a new fleet of helicopters to perform the scout/observation mission and complement the new Apache attack helicopter. This new fleet of scout helicopters is planned for production in the early 1990s. Nonetheless, the AHIP program for 1984-1988 would improve 328 scout helicopters; the total program would modify 578 scout helicopters.

The Congress could cancel the AHIP program, saving an estimated $0.2 billion in 1984 and $1.8 billion over the next five years relative to the Administration's program (see Table II-4). This would require the Army to rely upon the current OH-58 scout helicopter until the new fleet of scout helicopters is deployed in the early 1990s. Some of the target acquisition and designation mission could be offset by the new Apache attack helicopter and by the new Ground Laser Locator Designator (designed for the artillery). Both of these new systems are now in production, and each contains highly sophisticated acquisition and designation capabilites.

Cancel MX, Rely on Trident II. Increasing concern over the last decade regarding the survivability of land-based intercontinental ballistic missiles (ICBMs) has prompted DoD to develop a new missile, the MX, and to

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5. The former improvement results from the incorporation of the Mast Mounted Sight that contains a forward-looking infrared sensor and a laser rangefinder. The latter is achieved through the substitution of a four-blade main rotor for the existing two-blade main rotor, and improvements in the engine and transmission. No improvements are currently planned for the OH-58 airframe, however.

6. Originally, the Army had proposed the procurement of a new scout helicopter, called the Advanced Scout Helicopter. The Congress deleted the funds in 1977 and endorsed the modification program.

try to find a way to base it so that it can survive a Soviet nuclear strike. 7/ The MX missile is scheduled for flight tests in 1983. Capable of delivering 10 to 12 high-yield nuclear warheads and weighing nearly 100 tons, MX would be the largest and most accurate ballistic missile in the U.S. arsenal. The Administration has proposed the procurement of 226 MX missiles to support an operational deployment of 100.

In November 1982, the Administration proposed to base the MX missile in the so-called "Closely Spaced Basing" (CSB)--or "Dense Pack"--mode. This approach would cluster the missiles in superhardened capsules spaced about 1,800 feet apart in a narrow array about 14 miles long to take advantage of so-called "fratricide," in which incoming warheads--arriving closely behind their exploding predecessors--would themselves be destroyed or thrown off course by the nuclear effects of the detonations. The Administration estimates the total cost of the MX missile and basing system at $32.7 billion. Nearly $4.4 billion has already been spent, primarily in developing the missile. Deployment in CSB could begin in late 1986.

The CSB basing proposal engendered substantial controversy in the closing days of the 97th Congress. Funding for the first production missiles was denied. At the direction of the Congress, the Administration will reconsider the missile and basing system, reporting to the Congress no earlier than March 1, 1983. At that time, the Administration will either resubmit its proposal to place MX in CSB or propose an alternative. For purposes of discussion, this study assumes that the Administration again proposes basing 100 MX missiles in CSB, and that the missile would be survivable. 8/

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7. CBO analysis indicates that by the mid-1980s the Soviets could destroy up to 90 percent of the existing force of Minuteman missiles.

8. These estimates assume that MX survives in substantial numbers (roughly 60 percent) long enough to retaliate. Substantial technical doubts have been raised regarding the survivability of MX even in CSB. Press reports suggest that specialists believe that Soviet planners could defeat the system by introducing very large warheads, as well as other adjustments, to destroy very hard silos, although the technology to do this is not fully developed. The Administration believes that MX in CSB is likely to be survivable through this decade, and DoD has identified additional methods to improve survival prospects. These include further increases to capsule hardness, additional arrays for deceptive basing, ballistic missile defense, and deep underground

If it is survivable, MX in CSB would maintain the diversity inherent in a triad of strategic forces able to survive a Soviet first strike. The diversity of the triad would provide insurance against a Soviet technological breakthrough that might threaten one or more legs of the triad. It would also force the Soviets to mount research and development efforts against three types of U.S. strategic forces, each of which must be countered with a different system.

The Administration has also argued that continuing development and deployment of the MX would show U.S. resolve and provide a "bargaining chip" for use in strategic arms reduction talks.

Moreover, MX could be superior to other strategic weapons in its ability to destroy Soviet targets hardened against nuclear effects and do so promptly. Ballistic missiles, especially land-based missiles, can retaliate promptly because of their speed of delivery and rapid command and control. Submarine-launched ballistic missiles (SLBMs), while sharing the speed characteristics of ICBMs, pose greater command and control problems. Bombers, by contrast, take hours to reach their targets. This prompt, hard-target kill capability of ICBMs and especially of the MX could be particularly important in a limited nuclear war featuring a series of exchanges, when it would be critical to destroy Soviet targets promptly before they could launch another attack. In 1990, MX would contribute almost all of this country's survivable prompt, hard-target kill weapons. By 1996, the contribution of MX would range from 17 percent to 70 percent, depending on whether Trident II (D-5) submarine-launched ballistic missiles (SLBMs) are credited with a prompt-kill capability.

Based on broader measures than prompt, hard-target kill, however, the percentage contribution of the MX missile to U.S. strategic capabilities would be much smaller. By 1996, when the modernization program is completed, the contribution of the MX would range from about 5 percent of those capabilities to about 13 percent, depending on the measure of capability chosen, the scenario assumed for the nuclear exchange, and assumptions about arms control. If there was warning of an attack, the MX would contribute 5 percent of all U.S. warhead inventories likely to survive a Soviet first strike, and it would provide 7 percent of those surviving warheads capable of destroying Soviet targets hardened against a nuclear

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basing of additional missiles. Some of these options require the further development of technology; some of them can fairly be characterized as new basing modes; all of them would require substantial additional investment.

blast. Were a Soviet attack to occur as a total surprise--destroying U.S. bombers not on alert and submarines in port--the MX in 1996 could provide 7 percent of all surviving warheads and 13 percent of hard-target inventories. The contribution of MX would be larger in 1990, before the buildup of other forces is complete.

Under Administration plans, the primary capability against hardened targets in the future would be provided not by MX but by the Trident II (D-5) SLBM and the upgraded bomber force. The Trident II SLBM will be in operation by 1989, and will have counterforce capability roughly comparable to the MX. 9/ Trident II will be deployed on Trident submarines, which today are widely considered invulnerable when at sea and likely to remain so for the foreseeable future. While the present B-52 bomber force is not likely to continue to function successfully against improving Soviet air defenses, the new bomber force is likely to be successful until the end of the century, although not equal in promptness to the Trident II and the MX.

In light of the relatively modest quantitative contribution of MX to total U.S. strategic capabilities, together with the difficulty of developing a reliably survivable basing system, the Congress could choose to cancel the MX system, placing primary emphasis on the Trident II for future strategic missile modernization. Such a course would entail a shift in U.S. strategic force plans to a survivable "dyad" of forces rather than a triad. The present ICBM force would continue to provide limited deterrence (for example, a credible threat to launch under attack) as well as potential use in limited nuclear operations.

Dropping the MX in favor of Trident II would offer substantial budget savings: $27.8 billion in budget authority and $23.2 billion in outlays during the next five years (see Table II-4). If the Congress chose to continue emphasis on ICBMs, it could direct that some of the savings from canceling MX be used to develop a new, small road-mobile ICBM, considered by some to be the only option for a survivable land-based ICBM. The Congress could also initiate compensating investments--such as improved guidance systems--for the Minuteman ICBM force. The costs of these actions have not been deducted from the savings shown in Table II-4.

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9. Counterforce capability refers to characteristics such as yield and accuracy that enable nuclear weapons to destroy hardened military and command facilities as well as softer industrial/economic recovery targets. Promptness refers to the rapidity with which a response can be made. Counterforce weapons on ballistic missiles are prompt; those on bombers, which take hours to reach their targets, are not.

Scale Back Purchases of F-15s. The F-15 is the Air Force's front line air superiority fighter, widely regarded as the most capable fighter in the world. It is also a very expensive weapon system--so expensive that the Air Force developed a companion F-16 that, though less capable in many ways, is approximately 40 percent less expensive, so that DoD might purchase sufficient numbers of aircraft to modernize its air wings. Until two years ago, the Air Force intended to purchase a total of 729 F-15s and 1,388 F-16s. By 1982, DoD had largely completed purchases of the F-15 and was beginning to build up production rates of the F-16.

Last year, however, DoD announced plans to continue production of the F-15, proposing to buy 666 more (for a total of 1,395) at a total additional cost of $25.1 billion. DoD plans to request 48 F-15s in 1984; 72 in 1985; and 96 in 1986 and beyond. Those plans were criticized last year in the Congress. The House Armed Services Committee, noting "uncertainties regarding the affordability of the F-15 program expansion . . . and the absence of a comprehensive well-defined continental air defense program," scaled back the DoD request for 1983 from 42 to 30. 10/ In final Congressional action, 39 F-15s were authorized in 1983, and long-lead funds were cut back by half.

In light of continuing questions of cost, the Congress could choose to limit production of the F-15, holding purchases to 30 per year beyond 1984. This would hold open F-15 production facilities at minimally efficient rates, and would provide procurement beyond DoD's previously stated goal of 729 to assure attrition replacements. This would also offer substantial savings during the next five years relative to Administration plans, reaching $0.7 billion in 1984 and $9.9 billion over the coming five years, as shown in Table II-4, though it would raise unit costs by at least 4 percent in 1984.

Limiting F-15 production could jeopardize Air Force plans for air wing expansion and could delay modernization of continental air defenses. The Air Force pressed for further purchases of the F-15 as part of a plan to improve the U.S. air defenses against Soviet strategic bombers attacking the United States. Though current Soviet bombers have only a limited ability to conduct such attacks, the Soviets are thought to be developing a more capable bomber, perhaps similar to the B-1B.

On the other hand, slowing the F-15 buildup would give time to assess Soviet bomber developments without foreclosing the option of buying more

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10. Department of Defense Authorization Act, 1983, H. Rept. 97-482, 97 Cong. 2 sess. (1982).

later. It would also give the Air Force time to test and develop the new Advanced Medium Range Air to Air Missile (AMRAAM) which will be fitted on both the F-15 and the F-16. Under current plans, AMRAAM-capable F-16s will be available by 1985, though AMRAAM itself might not be fielded until 1986 or 1987. If successful, this missile would give much of the interceptor effectiveness of the F-15 to its less expensive counterpart, the F-16.

Limit Tanker Re-Engining, Supplemented by Less Expensive Alternative. The Strategic Air Command (SAC) operates 615 KC-135 aircraft (an early version of the Boeing 707) that serve as tankers to extend the range of bomber and other military aircraft. In recent years, the Air Force has contended that current tanker resources are inadequate for two reasons. First, a far larger number of military aircraft are potential users of aerial refueling today than in the past, when only bombers were likely users. The Air Force, for example, foresees substantial aerial refueling requirements for fighters or transports in the event of a NATO conflict or of a need to project forces to a distant theater such as the Persian Gulf. Second, current Air Force plans to introduce the B-1B and to modify B-52s to carry cruise missiles will increase tanker requirements. To satisfy all such demands, the Air Force has indicated that as many as 1,000 KC-135 tankers or their equivalent will be needed into the mid-1980s.

To meet that shortfall, the Air Force has proposed to install new-generation CFM-56 engines on existing KC-135 tankers. With these more powerful and more efficient engines, the tankers could carry greater fuel payloads while using less fuel for their own operations.

In recent years, an alternative re-engining program was proposed that would install on the KC-135s older engines currently used on 707's that are being retired from commercial service. These older engines (designated JT3Ds) would be thoroughly overhauled and checked before installation. The JT3D does not match all the performance characteristics of the CFM-56, but is substantially better than the KC-135's existing engine. CBO analysis using Air Force performance data indicates that the JT3D engine is an effective substitute for the CFM-56 on a large number of SAC refueling missions. It is dramatically more attractive on acquisition cost grounds: whereas the CFM-56 re-engining would cost approximately $22 million (in fiscal year 1984 dollars) per aircraft, the JT3D modification would cost $4 million.

For two years, the Air Force has requested funds exclusively for the CFM-56 modification program, only to have the Congress cut back the size of the request and add funds to purchase the less expensive JT3D engine to be used in National Guard and Air Force Reserve units. The Air Force has again this year requested procurement of only the CFM-56 modification. Previous CBO analysis indicated that, at one-fourth to one-third the cost, a JT3D force could provide about 95 percent of the refueling capability of the Administration's program through the 1980s, when demands will be at their highest. 11/

The JT3D-modified tanker would not equal the full potential performance of the CFM-56, however, and on certain missions their performance differences are substantial. Thus, the CFM-56 provides more flexibility of response to possible changes in missions. The CFM-56 is also about half as noisy as the JT3D, which in some areas near cities may be an important feature.

Reflecting these pros and cons, the Congress could direct the Air Force to hold down production of the CFM-56 re-engining program to its lowest economic production rate of three per month, and continue the JT3D modification program at a rate of three per month. Such an alternative would save an estimated $1.2 billion over the next five years (see Table II-4). A mix of re-engining programs would provide some CFM-56 aircraft, enabling the Air Force to take advantage of their capability on certain missions, but would also buy some of the cost-effective JT3D aircraft. Moreover, this alternative would provide re-engined tankers to National Guard and Air Force Reserve units, which otherwise would have to continue to operate the outdated KC-135s until near the end of the decade when they too might be re-engined with the CFM-56 engines.

Redirect Preliminary Development Efforts, Emphasizing Longer-Term Systems

DoD is currently developing several major new weapons systems designed to complement existing weapons. The new systems will incorporate improvements but will not be appreciably better than those currently in the inventory. At the same time, promising new technologies are emerging that could be important for the 1990s. The Congress could choose to terminate further work on certain current development efforts, emphasizing instead alternative approaches that incorporate newer technologies or satisfy unmet requirements.

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11. See Congressional Budget Office, Aerial Tanker Force Modernization (March 1982).

Restructure Naval Surface Combatant Procurement Programs. The Navy has launched an aggressive program to expand both the size and the effectiveness of its current fleet. While primary attention has gone to prominent programs, such as purchase of new aircraft carriers or nuclear attack submarines, about half of Navy spending on shipbuilding over the next decade will go for surface combatants. Three surface combatant programs are now ongoing:

- FFG-7-class frigates, with 50 ships built or under construction;
- CG-47-class cruisers, with 10 ships authorized and 17 more currently planned by the Navy; and
- DDG-51-class destroyers, now being designed for procurement beginning in 1985, with a total procurement of 63 currently planned by the Navy.

The DDG-51-class is the largest of the three programs in terms of budget requirements and number of ships. It will be similar to the CG-47 but less capable in some areas; it will not, for example, have helicopter support facilities and will carry 25 percent fewer missiles than the CG-47. Although the Navy is making a strong effort to hold down the cost of the DDG-51, it will still be an expensive ship. The cost goal is 75 percent of the cost of a CG-47-class ship for the average production ship, or over $800 million in 1984 dollars. Navy warships, however, have almost invariably experienced cost growth between the preliminary design stage--where DDG-51 is now--and actual construction. Recent reports suggest the Navy is considering even more stringent cost goals. Even if the Navy achieves its cost goals with the DDG-51, however, the total program cost for 63 ships would exceed that of any other Navy program.

The DDG-51 is a conservatively designed ship, with most of its features only marginally different from those used in earlier classes. New technical developments are emerging, however, that could have important implications for future warship design, capability, and costs. These include basic changes in design practice such as the Ship System Engineering Standards (SSES) technique and distributed combat system architecture, as well as changes in individual ship components that would permit ships to be rapidly modified in response to changing threats or improved technology. Incorporating such features would probably extend considerably the design and testing period required for a new surface combatant. At issue, therefore, is whether the Navy should redirect current design efforts to incorporate newly emerging technologies. The DDG-51 is projected to be the most numerous class of surface combatants since World War II; its construction program would continue into the 1990s and would be the most expensive procurement program currently contemplated by DoD.

The Congress could cancel further development of the DDG-51, directing the Navy to initiate longer-term development of a new surface combatant that would incorporate modular design with rapid refit capability. In the meantime, procurement of CG-47-class ships would continue, with CG-47 production expanded to compensate for those DDG-51s not funded during the next five years. This could be an important step in ensuring adequate production rates for the CG-47, now that annual ship orders will be split between two producers.

Specifically, this option would drop the nine DDG-51s and add three more CG-47 combatants to the Administration's program over the next five years. The current DDG effort would be redirected toward a less expensive, more flexible design, as discussed above. Authorization of the lead ship for this new class would take place in 1987 with long lead funds for four more ships in 1988. Development and design funds now programmed for the DDG-51, about $600 million through 1988, would be reallocated to this effort, including the SSES program and other efforts to develop modular sensors and weapons systems. Near-term savings in fiscal year 1984 from this option would be modest. Over the five-year period, however, this course would save about $6.2 billion in budget authority and $800 million in outlays.

The most significant savings, however, would be those realized beyond these five years if reductions can be made in procurement and life-cycle costs by a new design effort. With a unit cost now projected at more than $800 million per ship (considerably more in inflated dollars), and the total buy projected at 63 ships, the total cost of the DDG-51-class would exceed that for any class of warships ever procured at any time by any navy. 12/ Lowering the procurement and life-cycle costs of these ships would be an important step in holding down the cost of future naval forces.

Cancel the C-17, Restructure Program to Modernize Tactical Airlift Forces. In 1978, President Carter, responding to the need to establish a

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12. The 63 projected ships of the DDG-51 would cost at least $54 billion in terms of 1983 dollars even if there was no further cost growth during design and construction. By comparison, the six Nimitz-class carriers, including ships built, building, and authorized, would cost about $21 billion at 1983 prices, and the 10 Trident submarines built or authorized to date would cost about $15 billion at 1983 prices.

Rapid Deployment Force (RDF), directed the Air Force to expand its airlift resources to deliver such a force. The Air Force launched the CX program, designed to develop a new transport aircraft that could carry the bulky, heavy cargo typical of Army equipment and operate in areas with few, sparsely equipped airports. Shortly after the Reagan Administration took office, the Air Force held a competition and selected a winning design for the CX--the C-17 designed by the McDonnell Douglas Corporation. The Administration indicated, however, that it did not feel obligated to develop and field the C-17, and in January 1982 Secretary Weinberger announced his intention to satisfy the need for more airlift resources by buying updated versions of the C-5 transport now in the inventory.

Despite the selection of the C-5, the Air Force intends to continue development of the C-17, with the goal of fielding substantial numbers of the aircraft in the 1990s. It would replace the existing, smaller C-141 transport that complements the C-5 as the primary U.S. intertheater transport aircraft. The C-141 would be assigned to National Guard and Reserve units. The C-17 would be available as a backup if unexpected problems developed in fielding the C-5. The Congress appropriated $60 million in 1983 for continued development of the C-17, but directed that all but $1 million of that amount be taken from other lower-priority Air Force programs.

The C-17 should be a very capable aircraft. There is, however, probably a more pressing need in the future for a new aircraft designed primarily as a tactical airlift transport. Tactical transports are designed to move cargo within a war theater rather than between the United States and a theater. The existing fleet of C-130 tactical transports is capable but limited in abilities to carry the full range of Army equipment. The C-130 was designed in 1951 and, because of its small size, is unable to move most of the Army's modern combat vehicles. Although the C-17 was designed to have many of the features desired in the C-130 replacement, its primary design emphasis was on strategic airlift missions rather than tactical operations. As such, the C-17 may be larger than necessary and could be too expensive (at over $100 million each) to buy in large numbers, thereby limiting its suitability as a replacement for some or all of the fleet of over 500 C-130 transports.

The Congress could choose to cancel further development of the C-17, in view of the plans to proceed with the C-5. This would offer savings estimated at $3.5 billion over the next five years, as shown in Table II-4. Larger budget savings would occur later in the decade, when the majority of C-17s are planned for purchase. The Congress could also direct the Air

Force to study tactical airlift requirements for the 1990s and begin to develop a replacement aircraft for the C-130s. 13/

Impose Modest Force Structure Cuts and Rely on Allies to Provide Greater Contributions

Modest reductions in the size of U.S. forces would offer significant near-term savings in the fast-spending personnel and operating accounts. Those savings would be sustained if the force structure cuts were permanent. This would be at the expense of combat effectiveness, however. If the Congress selected such an approach, it might want to stress areas in which U.S. allies could take offsetting action.

The United States spends considerably more on national defense--as a percentage of gross national product--than its allies. Defense spending by the NATO allies averaged 3.8 percent of GNP in 1981; Japan's spending on national defense averages less than 1 percent a year. By contrast, in 1981 the United States spent 5.8 percent of its GNP on defense and is likely to spend about 7 percent by the mid-1980s. If the other countries could be persuaded to increase their contributions, the Congress could make corresponding cuts in U.S. forces. It is important to acknowledge the risk in such an approach, since there is no guarantee that U.S. allies would assume greater financial burdens.

Deactivate One Army Division. The U.S. Army consists of 16 active divisions and 8 reserve divisions. Of the active units, 4 are stationed in Europe, 1 in Korea, and 1 in Hawaii. The remaining 10 active divisons, and all reserve units, are stationed in the continental United States. While U.S. forces would be used worldwide should circumstances dictate, the primary emphasis in recent years has been on the reinforcement of NATO in the event of conflict with the Warsaw Pact. Consistent with the NATO Long-Term Defense Program, the United States could provide a total of ten divisions in the first ten days after mobilization.

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13. In the early 1970s, the Air Force developed four prototype aircraft (two each of two different designs) under the Advanced Medium Short-Takeoff-and-Landing Transport (AMST) program. That aircraft proved too expensive in the judgment of DoD and was not pursued at that time. A key element in the development effort should likely be "affordability."

Recently, some Members of Congress have expressed concern that the NATO allies are not contributing their share of resources to the defense of Europe. The Administration has indicated that it will continue U.S. policy commitments to reinforce NATO, but that the level of those commitments may be reduced. 14/ The Administration objected, however, when the Senate Appropriations Committee recommended that one combat brigade be withdrawn from Europe, and that the Army's end strength be reduced accordingly. Though the committee receded from that position, the Congress directed that U.S. forces in Europe not be expanded.

The Congress could direct the Army to deactivate one combat division--possibly withdrawing it from Europe--and reduce its active-duty end strength by 20,000 personnel, approximately the number of persons in a division and its immediate support. Table II-4 shows the savings associated with a reduction of one division of troops from the active Army, phased in over two years. Savings would total $200 million in 1984 and $2.4 billion over five years, from reduction in operating expenses as well as in pay and allowances for troops no longer in the Army. The division's current equipment would be redistributed to other units. Beyond the five-year period, an additional $1.9 billion (in fiscal year 1984 dollars) would also be saved by avoiding the purchase of new equipment to modernize the division. If a division was withdrawn from Europe, additional long-term savings could result from reduced lease costs for facilities returned to Germany. 15/

Withdrawing a division from Europe would alter U.S. commitments to NATO. The Administration has stated that it intends to provide ten divisions within ten days after mobilization, but this would be jeopardized if a division was withdrawn. Cutting a U.S.-based division instead would reduce the impact on combat readiness in Europe, though it would still affect reinforcement potentials.

Boost Canadian Support of NORAD. Since 1957, the United States and Canada have collaborated through the North American Air Defense (NORAD) command against strategic nuclear attack. Those defenses consist of the Distant Early Warning (DEW) line of radars far north, the Cadin-

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14. See Secretary of Defense Caspar W. Weinberger, statement before the House Budget Committee, September 23, 1981.

15. The return of these leased facilities to Germany could also require additional one-time costs. Without specific details concerning the facilities involved, estimates of costs and/or savings cannot be made.

Pinetree radars stretching across mid-Canada, and squadrons of interceptor aircraft. For several years, DoD has proposed upgrading the early warning radars. The Congress has rejected Air Force plans in the past, though the DoD has proposed this again in the 1984 budget.

The United States paid for the DEW line in its entirety and continues to pay all of its operating cost. It also paid for the installation of the Cadin-Pinetree line of radars and pays two-thirds of its operating cost, with Canada paying for the remainder. The Congress could insist that any upgrading of the DEW radar network be supported financially by the Canadian government and that Canada begin to pay one-third of current operating expenses. Details of a DEW radar upgrade were not available in time to provide an estimate of savings. Those savings shown in Table II-4--$0.2 billion over the five-year period--represent current operating costs only.

While small in the scale of U.S. defense expenditures, these savings would represent a significant increase in Canadian defense spending. It is fair to add that at present Canada spends less than 2 percent of its GNP on national defense, roughly one-fourth of U.S. defense spending as a percentage of GNP. 16/

Press for Japanese Purchase of AWACS for Pacific Defense. The Airborne Warning and Control System is a sophisticated radar and command post installed on military versions of the commercial Boeing 707. The Air Force currently owns or has on order 34 AWACS and proposes to buy 12 more for continental air defense and other tactical applications. In addition, 5 AWACS aircraft are being sold to Saudi Arabia and 18 to NATO. The Japanese government has also expressed interest in AWACS, which is considered particularly well suited to Japan's interest in defensive forces and in sealane and airlane surveillance.

The Congress could postpone additional purchases of AWACS for three years and direct the Administration to urge Japan to purchase six of the aircraft over that period. It would require six aircraft to keep one on continuous airborne alert. This would save $960 million in defense budget authority through the next five years (see Table II-4). These savings could become permanent if DoD chose to limit AWACS purchases to the existing 34 aircraft.

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16. In 1981, the United States spent roughly $730 per person on defense, and Canada roughly $211 per person (in U.S. dollars).

This approach would provide a specific basis for urging more Japanese spending, and on a mission appropriate to Japan's defensive interests. Though not under direct U.S. operational control, continuous AWACS capability in Northeast Asia by a U.S. ally would contribute to regional security and stability in a manner similar to the Administration's plans for the Saudi AWACS for Southwest Asia.

Delaying further U.S purchases of AWACS would postpone modernization of strategic air defenses for NORAD. However, some of the 34 AWACS currently in operation or on order could be pressed into service on an emergency basis to make up for the three-year delay in U.S. purchases.

Failing a Japanese response, this option might cause an expensive gap in AWACS production and lead to higher expenditures in the future if the United States had to pay to restart production facilities.

Limit Growth in Pay and Benefits

Over a third of DoD's 1983 budget authority is for compensation for military and civilian personnel, as well as retirement benefits for military retirees. (Civilian DoD retirees are covered under the Civil Service Retirement System, discussed in Chapter VIII.)

Reflect Savings in Outyears Created by 1984 Pay Freeze. In an effort to trim the 1984 defense budget request, the Administration has proposed no pay raise at all for military or civilian employees in 1984. This comes on top of last year's decision to limit pay increases to 4 percent, half of the amount requested by the Administration for military personnel.

When the freeze was announced, Secretary Weinberger stated his goal of requesting a catch-up raise in fiscal year 1985. A 6.1 percent pay raise has been programmed for 1985, which is estimated to be the percentage raise comparable to increases expected in the private sector for 1985. An Administration spokesman also indicated that DoD has programmed a "contingency" fund for a catch-up raise if the Secretary chooses to request such an increase next year.

If the Administration proposes a catch-up raise next year, there would be no longer-term savings associated with the decision to freeze pay in 1984. However, if future pay raises are limited to comparability adjustments, there might be significant longer-term savings. Sticking to comparability adjustments only in 1985 and beyond would save $7 billion in military pay over the five-year period. (Savings from changes in civilian pay would also affect the defense budget; these are discussed in Chapter VIII.)

The limit on the 1983 pay raises, coupled with no pay raise in 1984, will save money but will also reduce the services' ability to attract and retain personnel. Recruiting and retention have been at historical highs in recent years; thus, these limits on pay raises will probably not jeopardize the services' ability to meet requirements in 1984. But the services could have difficulty attracting and retaining enough personnel with the desired skills and backgrounds in the mid-1980s. If so, a catchup pay raise may be needed, which would eliminate some or all of the savings from the 1984 freeze (shown in Table II-4). Alternatively, the Congress could increase bonuses to meet shortages in critical skills; this would offset adverse effects in these critical skills while holding down costs.

Restructuring Military Retired Pay. The military retirement system currently provides substantial benefits for those who retire with more than 20 years of service, but no benefits for nondisabled persons who leave with fewer than 20 years of service. The cost of the system, $15 billion in 1982, has been rising steadily because of increases in the number of retired personnel and changes in the price level.

For 1983, however, the Congress sought to limit these costs. The annual cost-of-living adjustment for all retirees below age 62 was limited to one-half of the increase in the Consumer Price Index; those 62 or older continue to receive full COLAs. 17/ Under current law, this half-COLA provision will remain in effect through 1985. 18/ In addition, the Congress extended the waiting period between receipt of COLA adjustments from 12 to 13 months in each of the next three years. Together, these changes should save an estimated $830 million through 1985. These changes will, however, increase the number of career personnel who leave the military

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17. If increases in the CPI exceed those anticipated last year, then retirees under age 62 would receive a COLA equal to more than one-half the CPI.

18. In its budget for fiscal year 1984, the Administration proposed permanent enactment of the half-COLA provision (with no floor) for retirees below age 62. The Administration's budget submission apparently has been adjusted to reflect those savings. As such, the savings from the CBO option shown in Table II-4 would be overstated, since the bulk of those savings--at least in the 1986-1988 period--come from the half-COLA provision, and have already been incorporated in the Administration's program.

before qualifying for retirement, especially if the half-COLA provision is retained beyond 1985 in order to ensure continued savings.

The Congress could restructure the military retirement system further in order to retain most of the cost reductions while also alleviating some of the adverse effects on retention. Such a continued restructuring could have several features:

- Make the half-COLA provision for retirees under age 62 part of permanent law.
- Provide a one-time "catch-up" annuity adjustment for retirees at age 62. This adjustment would raise annuities for those older than 62 to levels that would have been attained with full COLAs. Although it would not make up for reductions in retired pay before age 62, it would ensure higher benefits for older retirees, which may be viewed as equitable, and would mitigate the adverse effects on retention caused by making the half-COLA provision permanent.
- Provide or "vest" some retirement benefits--beginning at age 62--for all military personnel who complete at least ten years of service. Earlier vesting should improve retention among trained personnel with between five and ten years of service, and thus offset still more of the adverse retention effects of the half-COLA provision.
- Base military retirement pay on an individual's three highest pay years, phasing in the change over the next three years. Under current law, retirement pay would eventually be based on the three highest pay years, but the change would not be made until around the year 2000. This faster phase-in would save about $590 million over the next five years and would help pay the costs of the catch-up adjustment and ten-year vesting.

Taken together, these changes should not reduce the costs of military retirement in 1984 but would save a total of $1.9 billion over the five-year period. Proponents argue that these savings could be achieved while improving military manpower management, enhancing retention of junior personnel, and weakening the incentive to retire immediately upon completing just 20 years of service. CBO estimates that, under this approach, retention of career personnel (defined as those with more than four years' service) would be about 1 percent better by 1989 than if the current half-COLA provisions were continued indefinitely but about 3.5 percent worse than under the retirement system in effect before passage of the half-COLA provisions.

Opponents of change in the military retirement system contend that such reductions in retired pay are tantamount to a breach of contract with current active-duty members and retirees, and thus will harm morale and risk making retention much worse than that estimated by CBO. Such adverse effects upon active-duty manpower could require increased outlays for other incentives--such as reenlistment bonuses--or special pay increases for personnel in key skills.

Limit Growth in Operations and Maintenance Accounts

Approximately 20 percent of current DoD budget authority goes to support operations and maintenance (excluding civilian pay) of existing plant and equipment. This includes maintenance of existing equipment, training activity, fuel and spare parts, and base operations, as well as many other things. Together these activities are commonly referred to as "readiness" spending since they contribute directly to the day-to-day capability of the military forces. Administration plans call for a 6.5 percent average real increase in annual funding for these readiness items over the next five years, with little change in the force structure. Presumably, higher funding will place current forces at a higher state of combat readiness and effectiveness.

Limiting growth in operations and maintenance (O&M) accounts would offer significant near-term savings, since operating accounts spend out quickly. Choosing this strategy would reflect a preference for retaining the scope of modernization and force build-up plans while accepting a somewhat higher risk if hostilities occurred in the interim.

In 1981 and 1982, the Congress appropriated increases in O&M spending that averaged 8.7 percent and 7.2 percent, respectively, on top of adjustments for inflation. Increases in 1983 were held to about 2 percent. The majority of these increases were used to buy additional readiness items, such as aircraft spares and war reserve munitions. The large increases in 1981 and 1982 were widely viewed as necessary to restore adequate levels of force training and operational capability. Between 1984 and 1988, the Administration plans to increase real O&M spending further by 8.4 percent in 1984, 7.6 percent in 1985, 6.4 percent in 1986, 5.9 percent in 1987, and 3.5 percent in 1988, or a compounded five-year increase of 36.1 percent in real terms.

The planned additions to military forces do not, however, seem to require these substantial increases in real O&M. By 1987, the Administration plans to increase active-duty personnel by about 8 percent. Under this plan, the United States will have added only about 42 more ships (an increase of 8 percent) and 500 more aircraft (a 9 percent increase). An exception is the Army, which plans to add 3,735 more tanks (a 30 percent increase) to its inventories, of which 1,000 tanks will be assigned to prepositioned storage in Europe. CBO estimates that the additional O&M required to support these new forces at today's spending rates would add only about 5 percent to real O&M spending over the 1983-1987 period. (No program detail for 1988 was available at time of publication.)

Thus, it appears that much of the planned increase in O&M spending must be designed to improve the levels of readiness of existing forces. Readiness may have fallen in the 1970s, as the United States cut back on overall defense spending. Unfortunately, the Department of Defense has no aggregate measures of readiness that indicate how far it fell, nor quantifiable goals that suggest how much it needs to be increased.

This is not to say that the Congress should allow no growth in real O&M spending. New, more complex systems may require more O&M. Concern has been expressed about certain areas of readiness--for example, the level of spare parts necessary to support wartime surge rates in aircraft utilization. In a period of fiscal austerity, however, it may be reasonable to limit the rate of growth of O&M to less than the Administration targets.

Table II-4 illustrates the savings that would be possible if the rate of growth in O&M was reduced by one percentage point in each year, 1984-1988. (The Congress reduced the 1983 requested rate of real growth by approximately 6 percentage points.) Savings under this approach would be $0.6 billion in 1984 and would total $12.6 billion over the next five years.

A variety of changes in O&M would be required to achieve this slower rate of growth. Some changes in 1983 included accelerating the decommissioning of 22 ships, postponing some ship overhauls, reducing selected flying-hour programs, and lowering somewhat depot maintenance activity in the Air Force. These actions saved an estimated $608 million in 1983. When additional reductions--such as foreign currency reevaluation and fuel repricing--are added, the total savings were about $3.6 billion in 1983.

Other Approaches to Achieving Savings in Defense Spending

The targeted cost reduction strategies presented in this chapter have been concentrated in procurement accounts, where the primary buildup in spending has taken place. There are many other areas in which efficiencies and savings might be achieved, though the details go beyond the limits of this chapter.

For example, closing or consolidating defense bases would reduce costs for personnel and for operations and maintenance, though savings are often consumed in the early years by the need to cushion local economic dislocation. A return to peacetime conscription could reduce costs, though probably only between $1 billion and $2 billion a year and then only if pay for new recruits was reduced. A more efficient defense procurement process might also cut costs, and in some degree this has been pursued by the Administration. 19/

The Congress could also cut defense costs by repealing or modifying certain laws that raise costs. For example, the 1931 Davis-Bacon Act and more than 70 related federal statutes require that wages paid on most federal and federally assisted construction projects equal the prevailing wage in the local area. Critics of the act claim that procedures used for calculating Davis-Bacon rates raise wages paid on federal projects above those prevailing in the locality. Repeal or modification of Davis-Bacon, it is argued, might result in significant budget savings, especially in the three largest federal construction programs: military construction, Environmental Protection Agency construction grants, and ground transportation construction. DoD has claimed, for example, that military construction costs could be cut by 2 to 4 percent if the Davis-Bacon act was repealed, or if DoD was exempted from its provisions. Actual savings could well be more modest. Estimated savings from changing procedures for calculating prevailing wages are discussed in Chapter VII.

Substantial savings might also be achieved by small efficiencies throughout the Department of Defense, with its more than 5,000 installations and properties. This would be facilitated if the Congress worked with the department to modify the incentives facing defense managers; currently, managers who reduce costs may simply achieve a lower budget. Managers might be allowed to keep a portion of verified savings from management efficiencies to apply toward projects that they feel are important but are not funded. Similarly, they might be allowed to request money--above their budgets--to finance projects that quickly repay their

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19. For a discussion of these issues, see Congressional Budget Office, Reducing the Federal Deficit: Strategies and Options (February 1982), especially pp. 51-54.

costs through savings from increased efficiency. This latter approach has already been tried but might be expanded.

CONCLUDING COMMENTS

The preceeding discussion specified a number of reductions that might be made in order to bring the increasing level of defense spending down in 1984 and beyond. As noted at the outset of this chapter, the debate on national defense in the 98th Congress will proceed at two levels. Broadly, the Congress will determine the aggregate level of spending it chooses to devote to national defense. At a more detailed level, it must choose specific programs in which to make cuts.

Even if all the reductions outlined above were made, the defense budget would still grow at approximately the rate specified in last year's budget resolution. Should larger cuts be desired, a more radical departure from Administration defense plans would be necessary. For example, a no-real-growth option would be an extraordinarily difficult course to follow, necessitating cancellation of most major program initiatives launched by the department, unless defense readiness is to be sacrificed.

CHAPTER III. SOCIAL SECURITY

The Social Security system faces serious funding problems in the near future and potentially major financing difficulties over the long run. In addition, because its outlays now exceed its revenues, the system is also contributing to the unified budget deficit as a whole. 1/ The system's two cash benefit programs--Old Age and Survivors' Insurance (OASI) and Disability Insurance (DI)--account for over one-fifth of the federal budget, and more than two-fifths of all benefits for individuals. 2/ Both the current financing problems of the Social Security system, and the large share of the budget that it represents, will make some consideration of spending reductions and revenue increases necessary in this program within the coming year. The President's bipartisan National Commission on Social Security Reform recently recommended a set of measures to improve the financial condition of the trust funds, which is now under consideration by the Congress.

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1. The unified budget deficit for a given year equals total federal revenues received in that year from sources included in the budget, minus total federal budget outlays in that year. Social Security revenues and outlays are treated in the same manner as other revenues and outlays, and no special allowance is made for their trust fund status. Reserves, which represent unspent funds from past years, do not affect the current year's budget deficit, since they have already been taken into account as previous years' revenues. If Social Security were removed from the unified budget, its year-to-year surplus or deficit would no longer affect the unified budget deficit, although its impact on the total federal budget and on the economy would, of course, remain the same.

2. This chapter concentrates on the outlays and revenues of the two cash benefit programs, so the term Social Security is used throughout to refer to the programs providing cash benefits to retired and disabled workers and their families and survivors. Issues relating to noncash benefits--that is, Medicare benefits, which are provided through Social Security's Hospital Insurance (HI) trust fund, and through the Supplementary Medical Insurance (SMI) program--are discussed in Chapter IV.

The Short-Term Financing Problem. The current financing problem is caused primarily by increases in benefit payments that have exceeded increases in payroll tax revenues, resulting in a continuing depletion of trust fund reserves. This situation has occurred because prices--and therefore, cost-of-living adjustments--have increased more rapidly than wages in recent years. As a consequence, the OASI trust fund, which provides benefits for retired workers and their dependents and survivors, will be unable to pay all benefits on time beginning in July 1983--despite having borrowed $17.5 billion from the DI and Hospital Insurance (HI) trust funds. The latter two trust funds, which provide benefits for disabled workers and their families and hospitalization benefits under Medicare, have higher reserve levels than the OASI fund, but nonetheless the combined balances of all three trust funds will decline to less than one month's worth of benefits by January 1984. For the 1984-1988 period, the annual deficit in the OASDI funds is expected to average $10.8 billion.

The Long-Term Financing Problem. In the longer run, Social Security must also reckon with the retirement of the post-World War II baby boom workers after 2010. The OASDI funds are projected to have a long-term deficit averaging approximately 13 percent of annual expenditures over the next 75 years, under the intermediate economic and demographic assumptions of the 1982 Social Security Trustees' Report. In general, proposals for changes to reduce this long-run deficit include a gradual phase-in period to allow individuals, employers, and private pension plans to adjust to the changes without severe dislocations. Because they would be phased in, however, such long-range changes--for example, lowering the level of initial benefits or raising the retirement age--would generally result in little or no savings in the short run. 3/

BUDGET HISTORY AND PROJECTIONS

Over the past three years, Social Security outlays grew by 50 percent, with roughly 80 percent of the growth resulting from annual benefit increases tied to the Consumer Price Index. Payroll tax revenues grew almost as rapidly--about 46 percent--but fell short of outlays in each year. As a result, the OASDI programs accounted for nearly $9 billion of the annual federal deficit, on average, in the 1980-1982 period.

3. For a more complete discussion of Social Security problems and options over the long run, see Congressional Budget Office, Financing Social Security: Issues and Options for the Long Run (November 1982).

The major reason why outlays have grown faster than revenues is that prices have risen faster than wages and salaries since 1979, and Social Security benefits are automatically adjusted, or indexed, to the rise in the Consumer Price Index, while payroll tax revenues increase with the growth of the taxable wage base. Moreover, high unemployment rates have adversely affected trust fund balances by decreasing the number of workers paying taxes, and they may also have increased outlays by inducing more people to retire early.

Although a moderate recovery is projected for the 1984-1988 period, OASDI outlays are expected to continue to exceed revenues in each of the next five years. This shortfall will occur in spite of the payroll tax increase already scheduled under current law. 4/ Some modifications in the program will be needed, therefore, in order to continue the timely payment of benefits.

Recent History, 1980-1982

Most of the benefit reductions legislated during 1980-1982 were directed at small, specific groups of beneficiaries, and therefore had little effect on overall OASDI outlays (that is, the combined outlays of both the OASI and DI trust funds). The major Social Security reduction included in the 1981 Reconciliation Act and subsequent legislation, for example, was the elimination of post-secondary students' benefits. This had a large impact on the beneficiaries affected, but in combination with several smaller changes, reduced the overall size of the Social Security cash benefit programs by only about 2 percent. 5/ This small reduction contrasts with the relatively large cuts in other entitlement programs, particularly means-tested programs. 6/

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4. The Social Security Amendments of 1977 scheduled increases in OASDI tax rates for 1978, 1979, 1981, 1982, 1985, and 1990.

5. The other major benefit cut enacted as part of the 1981 Reconciliation Act, the elimination of the minimum benefit, was later restored for those eligible for the benefit before January 1982 by the Social Security Amendments of 1981.

6. An entitlement program is a program that provides benefits to all persons who meet certain eligibility criteria, and its outlays are determined by benefit levels and the number of qualifying applicants. Means-tested programs restrict eligibility to those whose incomes fall below specified levels; other requirements must often be met as well.

The Administration did not propose, and the Congress did not enact, any specific modifications in Social Security for 1983. Instead, both branches awaited the recommendations of the National Commission on Social Security Reform, which had been established by the President in December 1981. The Commission's final report, submitted to the President and the Congress in January 1983, contained a set of recommendations designed to alleviate the short-term Social Security funding problems. 7/ These are examined later in this chapter.

Current Situation

CBO estimates that combined OASDI expenditures will total $171.4 billion in 1983, with OASI accounting for $152.7 billion and DI for $18.7 billion (see Table III-1). Income to the OASDI trust funds is estimated to be $165.5 billion in 1983, with 90.7 percent of that total representing payroll tax receipts. Borrowing from the HI fund and interest income constitute most of the remaining income. Because outlays are expected to exceed revenues in 1983, the OASDI funds will contribute to the 1983 federal budget deficit.

Baseline Projections, 1984-1988

OASDI expenditures are projected to rise from $171.4 billion in 1983 to $183.5 billion in 1984 and $236.8 billion in 1988. Current law OASI payments alone are expected to reach $216.1 billion by 1988. OASDI income is projected to grow by about $65 billion over the next five years and to reach $230.1 billion in 1988. Thus, without change, Social Security revenues will fall short of outlays in each of the next five years.

Under CBO's current projections, the OASI fund would require about $160 billion in additional resources over fiscal years 1983-1988 in order to maintain a 12 percent start-of-year fund balance over that period--the minimum reserve needed to avoid cash-flow problems during the year. 8/ If the OASI and DI funds are considered in combination, only about $71 billion

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7. The Commission's recommendations for the short term are also estimated to reduce the 75-year deficit by about two-thirds. The Commission could not agree on measures to eliminate the remaining one-third of the projected long-run deficit.

8. Since all cash benefits are paid on one day early in each month while payroll tax revenues are received continuously during the month, roughly 9 percent of annual calendar year outlays must be on hand at

TABLE III-1. CURRENT LAW PROJECTIONS OF SOCIAL SECURITY TRUST FUND OUTLAYS, INCOMES, AND BALANCES (In billions of dollars)

	Actual		Estimated	Baseline Projection				
	1980	1982	1983	1984	1985	1986	1987	1988
				Old Age and Survivors Insurance				
Total Outlays	103.2	137.9	152.7	164.4	176.5	189.1	201.8	216.1
Income a/	100.1	126.6	146.5	138.3	150.8	162.5	172.7	185.1
Year-End Balance	24.6	12.5	6.3	-19.8	-45.5	-72.1	-101.2	-132.1
Start-of-Year Balance as Percent of Outlays	26.8	17.3	8.2	3.9	-11.2	-24.1	-35.7	-46.8
				Disability Insurance				
Total Outlays	15.3	18.0	18.7	19.1	19.2	19.4	20.0	20.8
Income a/	17.4	21.4	19.0	26.8	32.7	37.4	41.0	45.0
Year-End Balance	7.7	6.8	7.0	14.8	28.3	46.3	67.2	91.4
Start-of-Year Balance as Percent of Outlays	36.6	18.8	36.0	37.0	77.0	146.0	231.2	323.9
				Combined OASI and DI				
Total Outlays	118.5	156.0	171.4	183.5	195.6	208.5	221.8	236.8
Income a/	117.4	148.0	165.5	165.0	183.4	199.9	213.7	230.1
Year-End Balance	32.2	19.3	13.4	-5.1	-17.3	-25.8	-34.0	-40.7
Start-of-Year Balance as Percent of Outlays	28.1	17.5	11.3	7.3	-2.6	-8.3	-11.6	-14.3
				Combined OASI, DI, and Hospital Insurance				
Total Outlays	142.8	190.8	210.4	227.8	245.3	265.8	288.3	311.6
Income a/	142.8	185.6	193.4	209.3	232.0	255.1	272.9	293.0
Year-End Balance	46.7	40.1	23.2	4.7	-8.6	-19.4	-34.7	-53.3
Start-of-Year Balance as Percent of Outlays	32.7	23.8	19.1	10.2	1.9	-3.2	-6.7	-11.1

NOTE: Minus signs denote a deficit.

a. Income to the trust funds is budget authority. It includes payroll tax receipts, interest on balances, and certain general fund transfers. Income in 1983 reflects interfund transfers as authorized under the Social Security Amendments of 1981. In order to illustrate better the operations of the trust funds under extended interfund or other types of borrowing or under tax rate reallocation, estimated interest payments owed by a trust fund when it shows a deficit are included as negative values in the income estimates of that trust fund.

in additional resources would be needed, since income received by the DI fund is expected to exceed its outlays, although its surplus would not entirely offset the OASI deficit.

A 12 percent start-of-year balance, however, provides no margin of safety for the trust funds, and could result in further financing problems if economic conditions prove to be only slightly worse than the CBO projects. In fact, Social Security is so sensitive to the performance of the economy that the National Commission on Social Security Reform decided that $150 billion to $200 billion in additional reserves would be necessary over the calendar year 1983-1989 period in order to provide adequate protection to the trust funds should the poor performance of the economy persist.

DEFICIT REDUCTION STRATEGIES

Substantial reductions in the growth of benefits, large increases in revenues, or some combination of the two will be necessary to pay Social Security benefits in a timely fashion through 1988. Such changes will almost certainly affect a large proportion of beneficiaries or taxpayers. For example, the estimated impact on Social Security of the 1981 Reconciliation Act--including the total elimination of the minimum benefit, which later was partly repealed--was to reduce projected outlays for 1982-1986 by about $22 billion, whereas OASDI needs at least $71 billion in additional resources in the 1983-1988 period. Moreover, the remaining options for this type of limited benefit reduction would provide even smaller savings than those already enacted. Similarly, most options that would increase trust fund revenues by increasing payments by relatively small groups of taxpayers would not yield enough new revenue to meet the projected needs of the trust funds.

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the beginning of each month. When evaluating the asset requirements for the trust funds on a fiscal year basis, however, balances equivalent to 12 percent of annual outlays represent a minimum reserve to avoid cash flow problems during the year. This reflects the fact that both expenditures and revenues vary during the year. The fluctuations on the benefit side occur largely as a result of annual benefit increases beginning each year in July. Tax revenues vary because of the timing of payments by state and local governments and by the self-employed, and because over the course of the year some workers reach the maximum earnings subject to the payroll tax and therefore stop contributing to the system for the remainder of the calendar year.

A wide range of possible outlay reductions that would affect most beneficiaries could generate significant savings in Social Security. To solve the short-term financing problem entirely through benefit reductions, however, would require either reductions in nominal benefits for current recipients or sharp reductions in benefits for new recipients. If such large benefit cuts are to be avoided, trust fund income will have to be increased, either through tax increases or through some form of general revenue financing. Although the introduction of general revenues would help to solve the Social Security financing problem, it would not reduce the federal budget deficit. Tax increases, in contrast, would both provide additional revenues for Social Security and narrow the budget deficit.

ACROSS-THE-BOARD REDUCTION STRATEGIES

Across-the-board changes in Social Security could provide significant outlay savings or revenue increases for both Social Security and the budget as a whole. Because the Social Security program is so large, even relatively small differences in cost-of-living adjustments (COLAs) or payroll tax rates, for example, could have major budgetary implications. By themselves, however, such changes might not provide the additional resources needed to solve the system's short-run financing problem.

Changes designed to remedy the long-run financing problem could also include either benefit cuts or tax increases. Possible benefit cuts that would generate long-run savings include altering the benefit formula and raising the age of retirement. Although they could produce significant long-run savings, such benefit cuts would affect relatively few beneficiaries over the next five years, and would therefore have relatively little impact in the near term. Similarly, payroll tax rate increases designed to reduce the long-term Social Security deficit would affect future generations of workers, but under current projections they would not need to be implemented until after 2010.

Changes Producing Additional Resources in the Short Run

In the next five years, either reductions in annual Social Security COLAs or increases in payroll tax rates could result in additional trust fund resources. 9/ These options would primarily affect current beneficiaries or

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9. Other across-the-board tax increases could also be enacted that would yield substantial new revenues. Alternatives to payroll tax rate increases that have been proposed in the past, but that are not analyzed here, include an income tax surtax, excise taxes, and taxes on imported fuels, with the resulting revenues in each case earmarked for the trust funds.

current taxpayers, and they would have similar impacts on all persons affected. Both of these types of options would also help to reduce the overall budget deficit.

Reduce Cost-of-Living Adjustments. COLAs for Social Security and other indexed entitlement programs could be reduced in several different ways. These options share some general advantages and disadvantages. 10/

Reductions in COLAs would slow the rate of growth of Social Security outlays, although they would not be sufficient to ensure the solvency of the system in the short run. Such reductions have often been suggested to offset the overindexing of benefits that resulted from flaws in the treatment of housing costs within the CPI, the index used to compute Social Security COLAs. Moreover, annual benefit increases in 1979-1981 exceeded average annual wage gains by a substantial margin--an outcome many observers believe was inequitable. In addition, current Social Security recipients are generally receiving rates of return on their contributions for Social Security that are very high compared with those that will be received by future retirees, both because of past flaws in the indexing mechanism, and because rates of return are relatively high for recipients before a pay-as-you-go system reaches full maturity.

On the other hand, COLA reductions would diminish the purchasing power of Social Security benefits over time and would lead to a higher incidence of poverty among the aged and disabled. Since most such reductions are cumulative from year to year, real benefits would be further reduced in each year of retirement if the cuts were sustained over an extended period; consequently, benefit levels, especially for the very old, could decline substantially. 11/ Although programs such as Supplemental Security Income (SSI) and Food Stamps provide some measure of protection

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10. In addition to COLA reductions designed to cut outlays, some analysts have proposed various options to tie benefit increases to an adjusted measure of wage growth instead of to the CPI, in order to reduce fluctuations in outlays relative to revenues. One such proposal, for example, would set the COLA equal to the increase in average wages minus 1.5 percentage points--the expected difference between wage and price growth over the long run. Such options are designed to stabilize the trust funds over the long term, rather than to produce short-run savings, and are therefore not discussed here.

11. Even if full CPI indexing was restored in future years, benefit levels would be permanently lower, as would the annual benefit increases--in dollars--because of the reduction in the base.

for Social Security recipients with low incomes, the stringent asset test under SSI and the unwillingness of many aged and disabled persons to apply for means-tested benefits prevent many of the elderly poor from participating in these programs. To the extent that Social Security recipients do participate in such programs, however, savings from reductions in Social Security benefits could be partially offset by increases in outlays for Food Stamps and SSI. One approach that would cut federal spending while protecting the poorest of the elderly would be to combine reductions in Social Security COLAs with liberalization of the asset test and increases in benefit levels under SSI.

Table III-2 presents the savings from four major COLA options:

- Delay the COLA by three months;
- Cap the COLA at the CPI increase minus two percentage points through 1988;
- Eliminate the 1983 COLA; and
- Eliminate the 1983 and 1984 COLAs.

The savings from these options over the 1984-1988 period would range from about $10.4 billion for a permanent shift of the COLA from July to October to $67.1 billion from eliminating both the 1983 and the 1984 COLAs.

These options illustrate several commonly proposed types of COLA reductions; clearly, many other ways to reduce COLAs could also be designed. For all of these options, the total savings achieved relative to current law, the timing of the savings, and the total impact on benefit levels would depend on the rate of inflation over the next few years. Since inflation rates have recently declined and are expected to continue to be lower than in the recent past, none of these options would result in savings as large as if they had been enacted in 1980 or 1981.

Increase Payroll Tax Rate. Increases in the payroll tax rate constitute a second across-the-board strategy for reducing the deficits of both the Social Security system and the overall federal budget in the near term. As with COLA changes, the increases could take various forms, which would differ in both magnitude and timing. Similarly, there are advantages and disadvantages that apply to all variants of this general approach.

The OASDI payroll tax is already scheduled to rise from the current 5.4 percent (or combined employer-employee rate of 10.8 percent) to 5.7

TABLE III-2. IMPACT ON THE SOCIAL SECURITY TRUST FUNDS OF ACROSS-THE-BOARD CHANGES a/ (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
			Short-Run COLA Reductions			
Delay the COLA by Three Months	2.0	2.1	2.1	2.1	2.1	10.4
Cap the COLA at the CPI Increase Minus 2 Percentage Points Through 1988	4.2	7.8	11.5	15.3	19.1	57.9
Eliminate the 1983 COLA	6.8	6.9	6.9	6.7	6.4	33.7
Eliminate the 1983 and 1984 COLAs	8.8	14.8	14.8	14.6	14.1	67.1
			Short-Run Payroll Tax Rate Increases			
Move 1985 Rate to January 1984	6.4	2.3	0	0	0	8.7
Move 1985 and 1990 Rates to January 1984	19.3	19.4	18.3	19.6	21.0	97.6
			Long-Run Changes			
Restrict Increases in Formula Bend Points to 75 Percent of Wage Increases	b/	0.1	0.2	0.3	0.6	1.2
Lengthen Computation Period by Three Years	b/	0.1	0.3	0.5	0.7	1.6

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a. The impact of these options on the federal budget deficit may be somewhat smaller than the trust fund effects shown here, due to offsetting increases in spending for other federal programs or reductions in federal tax receipts. For the options that would reduce spending, only the effects on outlays are shown in this table, because changes in budget authority (which includes interest) are uncertain when trust fund balances are negative and declining.

b. Less than $50 million.

percent in 1985 and 6.2 percent in 1990. 12/ If these increases were implemented earlier, additional revenues could be raised in the short run without affecting long-run tax rates. Moving the increase scheduled for January 1, 1985 to 1984 would generate $6.4 billion in additional receipts in 1984, and $2.3 billion more in 1985. 13/ If the 1990 rate became effective in 1984, additional revenues of $97.6 billion would be generated in 1984-1988.

Payroll tax rate increases would have the advantage of yielding substantial revenues, even with relatively small increases in the percentage of each worker's earnings going to pay for Social Security. In addition, payroll tax increases would reduce the need for benefit reductions, which could impose hardships on some recipients who may have little ability to adjust to unexpected changes in their incomes. Such tax increases would also continue the current method of financing Social Security.

On the other hand, tax rate increases would impose even higher payroll tax burdens on workers who have experienced Social Security tax-rate increases in four of the last six years--the OASDI tax rate has already risen from 4.95 percent in 1977 to a current level of 5.4 percent. 14/ For workers earning the maximum taxable wage, the effective tax increases have been even greater because the maximum has increased more than 100 percent over the same period, compared to a growth of about 50 percent in average wage levels. Moreover, moving the already-scheduled 1985 and 1990 tax increases to 1984 would represent a 15 percent increase in the Social Security taxes each worker would pay, and would reduce the take-home pay of workers, who have already experienced a decline in real earnings in recent years because of high inflation. In light of this effect, some observers have advocated providing income tax credits to offset some or all of the payroll tax increase. Such a tax credit would lessen or eliminate the

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12. Total Social Security tax rates--including the HI tax--are now 6.7 percent each for employers and employees, and are scheduled to rise to 7.05 percent in 1985, 7.15 percent in 1986, and 7.65 percent in 1990. The 1986 increase is to be allocated to the HI fund.

13. These estimates do not include possible offsetting reductions in income tax receipts which could occur as a result of slower wage growth or reduced profits.

14. Moreover, the HI tax rate increased from 0.9 percent to 1.3 percent over the same period, so that the total has gone from 5.85 percent to 6.7 percent, a total increase of 0.85 percentage points, or 14.5 percent.

effect of payroll tax increases on the deficit, however, and would essentially represent a form of general revenue financing.

Payroll tax increases may also have adverse effects on the performance of the economy. Economists generally agree that the ultimate burden of the payroll tax is borne either by workers (through lower real wages or slower wage growth) or by consumers (through higher prices), although businesses and the owners of capital may suffer reduced profits in the short run because they may be unable to adjust prices or wages quickly. Payroll tax rate increases may, therefore, raise the cost of labor in the short run and adversely affect employment or increase inflation. In addition, to the extent that payroll tax increases reduce real wages and increase prices, they may reduce consumption and the demand for goods and services. This is a matter of special concern now, when the rate of growth in the economy is already low.

Changes Affecting the Long-Range Financing Problem

Some OASDI changes primarily designed to address the projected long-range financing problem could also help to improve the financial status of the trust funds in the near term. As discussed earlier, most long-run options that would significantly reduce the benefits promised under current law include provisions for a gradual phase-in to allow workers and beneficiaries time to adjust their plans. Most proposals to raise the age of eligibility for retirement benefits, for example, are designed to be phased in after 1989. Even allowing for some phase-in, however, options such as changes in the benefit formula that would reduce initial benefits could produce some near-term savings. 15/

Change Benefit Formula. The benefit formula could be altered to reduce initial benefits for all workers becoming eligible in the future, which would slow the growth in outlays. This could be done, for example, by slowing the adjustments for wage growth in the components of the benefit formula known as "bend points." For persons first becoming eligible for benefits in 1983, a worker's basic benefit--referred to as the Primary Insurance Amount (PIA)--is computed under the following formula: 90 percent of the first $254 of the worker's Average Indexed Monthly Earnings (AIME), plus 32 percent of the next $1,274 of AIME, plus 15 percent of the

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15. For analysis of long-run financing options, see Congressional Budget Office, Financing Social Security: Options for the Long Run (November 1982).

AIME in excess of $1,528. 16/ Under current law, the formula's bend points--$254 and $1,528--are increased each year by the increase in average earnings in the economy. If these bend points were increased more slowly than wages--say, by 75 percent of annual wage increases--the savings in Social Security outlays would amount to about $1.2 billion for the 1985-1989 period. Such a proposal would also yield considerable long-run savings.

Under this proposal, the benefit formula would change so gradually that benefits for future retirees would not be lower in real terms--under current economic assumptions--than those received by workers now retiring. The gradual reduction in benefits would also give future beneficiaries some time to adjust to the change. On the other hand, this proposal would result in a further reduction in the rate of return on contributions for future retirees who, under current law, will already receive lower returns than current retirees. Moreover, this type of benefit reduction would increase the likelihood that the rate of return to high-wage workers would fall below what they could obtain in private markets.

Lengthen the Computation Period by Three Years. A second way to reduce initial retirement benefits for most retirees would be to change the number of years included in the benefit computation formula. As mentioned above, Social Security retirement benefits are based on workers' AIME. The number of years that currently must be included in the benefit computation formula is determined in part by the year in which the worker reaches age 62. 17/ The option discussed here would add three years to the AIME computation period, bringing it to the year in which the worker reaches age 65. Lengthening the averaging period would generally lower benefits, particularly for early retirees, by requiring more years of low earnings to be factored into the benefit computation. This proposal, applied to persons turning 62 after December 31, 1983, would save $1.6 billion during the next five years.

Some would support such a change on the ground that the number of years included in the calculation of AIME should be based on the age of

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16. AIME is an adjusted measure of average monthly earnings over most of a worker's years of covered employment.

17. Specifically, the length of the computation period is five years less than the number of years after 1950 or attainment of age 21, whichever is later, and before the worker reaches age 62, dies, or becomes disabled. Wages earned after a worker reaches age 62 may replace earnings from earlier years if this increases the benefit received. The averaging period for a worker turning age 62 in 1983 is 27 years, and will reach 35 years for those attaining age 62 after 1990.

eligibility for full benefits, not for reduced early-retirement benefits. Moreover, the longer averaging period--which would generally affect those retiring before age 65 the most--would reduce incentives for early retirement. On the other hand, because many beneficiaries elect early retirement for reasons such as poor health or joblessness, a longer computation period could reduce benefits for those recipients who are least able to continue working. Other workers who could be disproportionately affected include those who stop or interrupt their careers--for example women who remain at home to raise children.

TARGETED REDUCTION STRATEGIES

Social Security benefit reductions and revenue increases could also be focused on smaller groups of beneficiaries or workers. In order to achieve the same net effect on the trust funds and the budget as across-the-board strategies, such targeted changes would need to have much larger impacts on the affected individuals. [18] On the other hand, such changes might be desirable for other reasons--improving work incentives for older workers, focusing benefit reductions on those less in need, or providing more uniform tax treatment under either the Social Security payroll tax or the federal personal income tax, for example. Even if all the options discussed below were combined, however, the aggregate savings would not be sufficient to ensure solvency for the trust funds.

Benefit Reductions

Benefit reductions that would affect specific groups of beneficiaries include:

- Eliminating benefits for children of early retirees;
- Applying the same limit on maximum family benefits for OASI beneficiaries as is used for families receiving DI; and
- Increasing the waiting period for DI benefits by one month--that is, to six months.

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18. Some types of reductions might generate savings for Social Security, but much smaller savings for the overall budget as a result of increased spending for means-tested programs such as Supplemental Security Income, veterans' pensions, and food stamps. In such cases, participants in several programs would not necessarily be greatly affected by the Social Security cuts.

Eliminate Benefits for Children of Early Retirees. As long as a child of a retired worker is unmarried and under age 18, that child is eligible for a Social Security benefit equal to one-half of the basic benefit, subject to a dollar limit on the maximum amount received by any one family. 19/ If such benefits were eliminated for the children of retirees aged 62 through 64, the savings would total about $1.6 billion over the next five years (see Table III-3).

TABLE III-3. IMPACT ON THE SOCIAL SECURITY TRUST FUNDS OF TARGETED STRATEGIES TO REDUCE SOCIAL SECURITY BENEFITS a/ (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Eliminate Benefits for Children of Early Retirees	b/	0.2	0.3	0.5	0.6	1.6
Tighten the Limit on Family Benefits for OASI Beneficiaries	0.1	0.2	0.4	0.6	0.8	2.1
Increase the Waiting Period for DI Benefits to Six Months	0.2	0.2	0.2	0.2	0.2	1.0

a. The impact of these options on the federal budget deficit may be somewhat smaller than the trust fund effects shown here, due to offsetting increases in spending for other federal programs or reductions in federal tax receipts. For the options that would reduce spending, only the effects on outlays are shown in this table, because changes in budget authority (which includes interest) are uncertain when trust fund balances are negative and declining.

b. Less than $50 million.

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19. Benefits for post-secondary school students between the ages of 18 and 22 are currently being phased out.

This option might encourage some workers to stay in the labor force longer, since the younger workers are, the more likely they are to have children under 18 years of age; thus, under current law some workers under age 65 may be encouraged to retire early, while their children are still eligible for benefits. 20/ On the other hand, some families in which the parent was unable to continue working would receive lower benefits.

Tighten the Limit on Family Benefits for OASI Recipients. The current limits on maximum family benefits are stricter for DI beneficiary families than for OASI families. Under current law, the maximum DI family benefit equals the lesser of 85 percent of the worker's AIME (but not less than 100 percent of the PIA) or 150 percent of the PIA, whereas the OASI maximum ranges from 150 percent to 188 percent of the worker's PIA. 21/ If the DI limit were applied to all newly eligible OASI beneficiaries beginning in 1984, the 1984-1988 savings would total about $2.1 billion.

Besides eliminating the present difference between the two programs and reducing OASI outlays, this option could also increase work effort by lowering benefits relative to earnings. Under current law, some OASI beneficiary families receive benefits that exceed pre-retirement after-tax earnings. On the other hand, the change would reduce benefits more for families with low basic benefits than for those with higher benefits--that is, it would make the system less progressive. In addition, in a period of high unemployment, little additional work effort among older workers is likely to occur.

Increase the Waiting Period for DI Benefits to Six Months. Disabled workers are required to be continuously disabled for five months before they are eligible for Social Security disability benefits. If the waiting period were increased to six months--the length before 1972--for workers becoming eligible after 1983 the five-year savings would amount to $1.0 billion.

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20. In many cases this proposal would produce only a small reduction in benefits because of the family maximum benefit provision, which limits benefits payable from one earnings record to 150 percent to 188 percent of the worker's basic benefit. Thus, the increase in a household's total benefits attributable to the presence of eligible children would often be quite limited, and the work disincentive effects of these benefits might not be large.

21. More specifically, the OASI maximum family benefit in 1983 is computed under the following formula: 150 percent of the first $324 of PIA, plus 272 percent of the PIA over $324 through $468, plus 134 percent of the PIA over $468 through $610, plus 175 percent of the PIA over $610.

This change would make DI eligibility rules conform to other Social Security provisions, as well as to many private disability plans. The Social Security Amendments of 1981, for example, required that the Social Security payroll tax be applied to the first six months of sick pay. A lengthening of the waiting period might also discourage some potential DI recipients from applying for benefits, although this impact would probably be very small. On the other hand, lengthening the waiting period would deny one month of benefits to all new DI beneficiaries, some of whom would have little income from other sources and high medical expenses.

Revenue Increases

Tax measures could also be targeted on portions of the beneficiary or working populations. Options analyzed here include:

- Taxing 50 percent of Social Security benefits for families with total incomes above $12,000 (individuals) and $18,000 (couples); and
- Increasing the self-employed tax rate to the combined employer-employee rate and allowing half of the payroll tax to be deducted as a business expense.

Tax 50 Percent of OASDI Benefits for Families with Total Incomes Above $12,000 (Individuals) and $18,000 (Couples). One way to generate new federal revenues would be to subject a portion of Social Security benefits to the personal income tax, as is done for Unemployment Insurance (UI) benefits received by those with incomes over certain limits. Under the proposal examined here, 50 percent of those benefits that, in combination with other income, result in total family incomes exceeding $12,000 for individuals and $18,000 for couples would be included as income for income tax purposes. 22/ This option would produce an estimated $29.7 billion in federal revenues during the 1984-1988 period (see Table III-4). If these receipts were channeled into the trust funds, their financial status would be improved by an equal amount.

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22. This is the same tax treatment as that accorded UI benefits, except that all of UI benefits, rather than half, are included as income for those with incomes substantially over the thresholds. For those with incomes near the thresholds, the proportion of benefits that is subject to income taxes is graduated from 50 to 100 percent, depending on how far the family is above the income limits.

TABLE III-4. REVENUE GAINS FROM TARGETED STRATEGIES TO INCREASE SOCIAL SECURITY TAXES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Tax 50 Percent of OASDI Benefits for Families with Total Incomes Above $12,000 (Individuals)/ $18,000 (Couples)						
Trust fund revenues	1.7	5.8	6.6	7.4	8.2	29.7
Unified budget revenues	1.7	5.8	6.6	7.4	8.2	29.7
Increase Self-Employed Tax Rate to Combined Employer-Employee Rate and Allow 50 Percent of Payroll Tax to Be Deductible						
Trust fund revenues	0.9	2.7	2.9	3.1	3.3	12.9
Unified budget revenues	0.4	1.3	1.4	1.5	1.6	6.2

The current practice of excluding Social Security benefits from taxation is not based on specific legislation, but rather on a 1941 Internal Revenue Service ruling that they are in the nature of welfare payments. In 1941, most recipients were classified as poor. Although many beneficiaries are still poor--about 15 percent of the elderly have incomes below the poverty line--most recipients are not. Moreover, the income limits in this proposal would protect even those well above the poverty line from any increases in income tax liabilities.

Taxation of Social Security benefits would reduce the differences in treatment between Social Security benefits and other pensions and would be similar to an income-targeted benefit cut. 23/ In addition, it would remove the incentive to retire early that results because the tax-exempt nature of Social Security benefits raises the value of benefits relative to earnings. Taxing benefits could also reduce differences in the return received on their contributions by those in different generations. Current Social Security recipients generally receive benefits well in excess of their past contributions. If this excess of benefits over contributions is reduced, lower tax payments will be needed from the present generation of workers.

On the other hand, beneficiaries who had earnings at or near the maximum taxable level would be more likely than others to have other sources of retirement income and thus to be affected by this proposal, which would further reduce rates of return on contributions received by such workers. In addition, if revenues were channeled to the trust funds, this type of proposal might also be seen as a form of general-revenue financing for Social Security, which some oppose. They believe that this approach would set a precedent for increasing general revenue support in the future and would lessen the fiscal discipline imposed by payroll tax financing. They also point out that the taxes on UI benefits are not returned to that program's trust fund, and thus it would not be parallel treatment to increase Social Security revenues in this manner.

Increase the Self-Employed Tax Rate to the Combined Employer-Employee Rate and Allow 50 Percent of Payroll Tax to Be Deducted. The OASDI tax rate that applies to self-employment earnings is roughly 75 percent of the combined employer-employee rate. Increasing the self-employed rate to the total applied to the earnings of wage and salary workers would raise an additional $0.9 billion in OASDI revenue in 1984, and $12.9 billion for the 1984-1988 period. If, at the same time, one-half of the tax payments of the self-employed were made deductible for income tax purposes, unified budget revenues would increase by a net amount of $0.4 billion in 1984 and $6.2 billion over the next five years.

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23. For example, a 1983 retiree aged 65 who always earned the maximum earnings under Social Security would receive approximately $8,700 in Social Security benefits in 1983 and, if there were no other sources of income, would pay no income taxes. On the other hand, if this amount were the benefit paid under another pension plan--such as Civil Service Retirement--and the employee contributions had already been exceeded, the individual's income tax liability for 1983 would amount to about $640, assuming the standard deduction was used.

The combination of these two changes in tax law would result in a uniform treatment of all earnings for both Social Security and income tax purposes, regardless of whether they were those of the self-employed or of wage-and-salary workers. On the other hand, this proposal would increase total tax liabilities--that is, Social Security taxes and personal income taxes--for most self-employed individuals. Only the self-employed for whom the entire payroll tax deduction would come from taxable income in the 50 percent marginal tax bracket would be unaffected; the largest increases in overall taxes would be paid by self-employed workers with the lowest incomes. Moreover, this proposal essentially represents a general revenue infusion, which some oppose.

Extend Social Security Coverage

A third type of targeted option that would generate additional resources for Social Security--and, to a lesser extent, for the unified budget --would be to extend Social Security coverage to some employment now not covered under the system. Approximately 90 percent of all jobs in the economy are covered under Social Security. Three major groups of workers, however, could be added to the system:

- Federal civilian employees;
- State and local government employees; and
- Employees of nonprofit organizations. 24/

Extending Social Security coverage to these additional groups of workers would also eventually cause them to receive higher Social Security benefits, raising outlays as well as revenues in the long run. The arguments for and against coverage differ by type of worker and are discussed separately below.

Cover Federal Civilian Workers. If all new federal employees, as well as those with fewer than five years of service, were covered by Social Security beginning in 1984, OASDI trust fund income would be increased by about $12.6 billion over the 1984-1988 period (see Table III-5). The federal workers then covered under Social Security would also participate in a revised Civil Service Retirement (CSR) plan that would supplement Social Security. The impact of this option on unified budget revenues would depend on the specific modifications enacted in the CSR system.

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24. Of these three groups, 90 percent, 30 percent, and 20 percent, respectively, are not now covered by Social Security.

TABLE III-5. REVENUE GAINS FROM EXTENDING SOCIAL SECURITY COVERAGE (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Cover Federal Civilian Workers with Fewer Than Five Years of Service						
Trust fund revenues	1.1	1.9	2.6	3.2	3.8	12.6
Unified budget revenues a/	0.6	1.0	1.3	1.6	1.9	6.4
Cover New State and Local Government Employees						
Trust fund revenues	0.1	0.2	0.4	0.5	0.7	1.9
Unified budget revenues	0.1	0.2	0.4	0.5	0.7	1.9
Cover All Employees of Nonprofit Organizations						
Trust fund revenues	0.9	1.3	1.6	1.8	2.1	6.7
Unified budget revenues	0.9	1.3	1.6	1.8	2.1	6.7

a. Estimate is based on the assumption that the CSR contribution rate would be unaffected, so new federal employees would pay both Social Security taxes and CSR contributions. Alternatively, if the supplementary pension plan paralleled most private plans by requiring no employee contribution, reductions in the federal deficit would be much smaller and would primarily consist of employers'-share payments from the Postal Service.

Proponents of coverage for federal workers argue that approximately three-quarters of all federal annuitants eventually receive Social Security benefits, either on the basis of their own nonfederal earnings or as spouses of Social Security beneficiaries. Also, career federal workers who spend a relatively small proportion of their working lives in covered employment receive higher rates of return on their Social Security contributions than most workers, as a result of the progressive benefit formula that was designed to help those with low lifetime earnings. If federal workers were covered by Social Security, they would pay the same amount for their benefits as other workers with similar total earnings. In addition, many federal workers would receive better disability and survivor protection under Social Security than under the present CSR system, especially those who die or become disabled before accruing five years of federal employment.

Extending Social Security coverage to federal employees would require modification of the Civil Service Retirement system to reflect the Social Security payroll tax and benefit structure, however (see Chapter VIII). Depending on the changes in the CSR system, at least some career federal workers would be likely to receive lower benefits than under current law. The CSR system, for example, has a less stringent definition of disability and earlier eligibility ages for retirement benefits than does the Social Security system. 25/

Cover New State and Local Government Employees. Under current law, state and local governments have the option of not participating in the Social Security system and, as a result, about 30 percent of their employees are not currently covered. Gradually bringing these jobs into Social Security by covering new state and local employees would raise $1.9 billion in 1984-1988 and would reduce the unified budget deficit by a like amount.

The advantages of this proposal for state and local workers are similar to those for federal workers. In particular, Social Security coverage is portable--that is, transferable from job to job--and disability and survivors' benefits are often better, particularly for younger workers.

On the other hand, imposing coverage of all new state and local government workers could encounter opposition on two grounds--constitutional difficulties and state and local government costs. There is considerable disagreement about whether the federal government can, under the Constitution, require states to pay the employer share of the payroll tax. In

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25. This is true not only of the CSR system. The requirements of disability programs that are available through private employers are generally less strict than those of the DI program.

addition, the costs to these governments of paying both Social Security contributions for current workers and retirement benefits for current retirees--since many of these plans, too, are funded on a pay-as-you-go basis--could be greater than the costs of their current systems. These increased costs would be incurred at a time when many state and local governments are in financial distress.

Cover All Employees of Nonprofit Organizations. Social Security coverage of the employees of nonprofit organizations is now voluntary. Mandatory coverage starting in 1984 would generate $6.7 billion in new trust fund revenues during the next five years and an equal amount in total federal revenues. The advantages for these employees would be the same as for state and local workers--a benefit package that is portable, and in many cases more generous than their current one.

On the other hand, for many nonprofit employers, Social Security coverage would represent a substantial increase in the costs of employment. Since the reason that many of these organizations are not part of Social Security is its cost, mandatory coverage might lead to some reduction in employment.

RECOMMENDATIONS OF THE NATIONAL COMMISSION ON SOCIAL SECURITY REFORM

In its final report, the National Commission on Social Security Reform (NCSSR) recommended a set of proposals that, if enacted, would provide additional trust fund revenues or decreased outlays that it estimated would total $168 billion over calendar years 1983-1989. The recommended financing package, therefore, would achieve the goal of $150 billion to $200 billion in additional resources that the NCSSR agreed was required to provide adequate funding for the OASDI programs in the event that the economy performs poorly. The proposals would do considerably less to improve the outlook for federal budget deficits, however, because roughly one-third of the $168 billion represents either transfers from the general fund or amounts that would be offset by increases in spending for other federal programs or by reduced tax revenues.

Certain recommendations, such as expanding the Board of Trustees, removing the Social Security and Medicare trust funds from the unified budget, and reallocating the tax rates between the OASI and DI funds, address administrative or accounting concerns and would have no direct impact on either Social Security financing or the overall federal deficit. Other proposals, such as indexing benefits by the lesser of wage or price increases when trust fund balances are low, could have OASDI financing and federal budget effects, but only under certain economic conditions that the CBO does not currently project.

This section provides a brief analysis of the NCSSR's recommendations and their implications for reducing federal budget deficits in the fiscal year 1984-1988 period. As such, the estimates cannot be directly compared to the commission's, because the latter's estimates are on a calendar year basis and extend through 1989. 26/

The commission recommendations that would have major short-term impacts on the trust funds include:

- Delaying the COLA six months;
- Taxing OASDI benefits for higher-income recipients;
- Increasing payroll tax rates in 1984 and 1988;
- Increasing the tax rate for self-employed workers;
- Extending coverage to new federal workers and all employees of non-profit organizations; and
- Crediting the trust funds for gratuitous military service wage credits.

Many of these proposals are variants of options discussed above.

Postpone the Cost-of-Living Adjustment

The NCSSR proposed that OASDI benefits be reduced by enactment of a permanent six-month delay in the annual cost-of-living adjustment. Thus, the annual COLA that currently affects the June benefit (received by beneficiaries in July) would be reflected in the following December's check (received in January) instead. The CBO estimates that this change in the

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26. Moreover, the commission's report is not specific with regard to some of its proposals--for example, the details of the phasing-in of benefit taxation for those with incomes over the taxable thresholds are not discussed. CBO's estimates may also differ from the commission's, therefore, as a result of differences in assumptions regarding the implementation of the proposals.

COLA would reduce OASDI payments by $24.1 billion over fiscal years 1983-1988 (see Table III-6). At the same time, the commission proposed that the SSI program be modified to allow beneficiaries receiving both SSI and Social Security benefits to retain $30 more in total benefits each month to offset the impact of the Social Security COLA delay. Consequently, the OASDI savings would be offset by about $4.2 billion in increased spending for SSI over the same period. In addition, the proposed change would increase benefit payments in other programs, resulting in further reductions in the budget savings of about $0.8 billion over the same period. 27/

Tax Social Security Benefits

The commission also recommended that one-half of OASDI benefits be considered as taxable income for recipients with adjusted gross income (not including OASDI benefits) of at least $20,000 if single, and $25,000 if married and filing jointly. The resulting increase in federal revenues would be credited to the OASDI trust funds.

As discussed earlier in this chapter, the current tax treatment of OASDI income differs from that accorded other pensions. The commission's proposal would move in the direction of comparability, but the income thresholds, and the fact that only 50 percent of benefits (rather than the excess of benefits over contributions) would be taxed, would continue some preferential tax treatment of Social Security benefits. Although taxing benefits would increase revenues rather than reduce outlays, many view the proposed change as more closely approximating an income-targeted benefit cut instead of a tax increase.

In recommending this tax treatment of benefits, the commission acknowledged that its specific proposal would result in greatly different tax liabilities for persons with incomes close to the thresholds, and it assumed that this "notch" problem would be corrected in the legislative process. Consequently, two illustrative tax treatments are considered here. The first approximates the current practice for taxing UI benefits. More specifically, if adjusted gross income plus 50 percent of OASDI benefits exceeded the $20,000/$25,000 thresholds, then one dollar for each two dollars of the excess would be added to adjusted gross income up to the limit of 50 percent

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27. These estimates are based on the assumption that the SSI COLA would not be delayed six months, since the commission did not specify any change. Offsetting increases in SSI and other programs would be much smaller if the SSI COLA were also delayed.

TABLE III-6. ESTIMATED IMPACT OF THE NATIONAL COMMISSION'S PROPOSALS ON OASDI TRUST FUNDS (In billions of dollars)

	1983	1984	1985	1986	1987	1988	Total 1983-1988
			Trust Fund Outlay Reductions				
Delay COLA from July to January	1.7	3.8	4.2	4.5	4.7	5.2	24.1
Miscellaneous Benefit Provisions a/	0	-0.1	-0.2	-0.3	-0.3	-0.4	-1.3
Total Outlay Reductions	1.7	3.7	4.0	4.3	4.4	4.8	22.8
			Trust Fund Income Increases				
Tax 50 Percent of OASDI Benefits b/	0	1.2	4.2	4.9	5.6	6.4	22.4
Increase Payroll Tax Rate	0	6.4	2.3	0	0	10.3	19.0
Increase Self-Employed Tax Rate	0	1.0	3.0	2.9	3.1	3.5	13.6
Extend Coverage c/	0	1.0	1.9	2.5	3.2	4.3	12.9
Credit Trust Funds for Military Wage Credits and Reimbursement for Uncashed Benefit Checks	19.9	-0.3	-0.4	-0.4	-0.1	-0.1	18.6
Total Income Increases	19.9	9.4	11.1	9.9	11.8	24.5	86.6
Total Reductions in Outlays and Increases in Income	21.6	13.1	15.1	14.3	16.2	29.3	109.6
Estimated Increase in Interest Income	0.3	2.9	4.4	5.8	6.8	8.3	28.5
Total Increase in OASDI Trust Funds	21.9	16.0	14.5	20.0	23.0	37.6	138.1

NOTE: Preliminary CBO estimates. Components may not add to totals due to rounding. Negative numbers indicate outlay increases or revenue reductions.

a. Provisions include increasing benefits for certain groups of widowed and divorced persons, and decreasing benefits to persons with pensions from employment not covered by Social Security.

b. Estimate assumes that taxes on OASDI benefits would be phased in the same way as are taxes on Unemployment Insurance benefits.

c. Estimate includes effect of prohibiting the withdrawal of state and local governments from Social Security.

of all Social Security income. This formulation would eliminate the notch and would yield roughly $22 billion in new revenues over the 1984 '988 period, but it would increase income tax liabilities for some taxpayers with adjusted gross incomes below the threshold. 28/ This type of tax treatment would increase tax liabilities for about 3.3 million tax-filing units.

An alternative treatment would limit the impact of the proposal to only those with adjusted gross income (not including Social Security benefits) at or above the $20,000/$25,000 thresholds. One possible plan would add one dollar of benefits to taxable income for every two dollars of adjusted gross income above the threshold, up to a maximum of 50 percent of benefits. While this treatment would lessen the effects of the notch somewhat, and would not affect any beneficiaries who now have taxable incomes below the thresholds, it would also yield about 15 percent less in new revenues than would a phase-in like that used in the UI program.

Increase Payroll Tax Revenues

Under the NCSSR's recommendations, payroll tax receipts would be increased in three ways:

- Raising the payroll tax rate in 1984 and 1988;
- Raising the self-employed tax rate to the combined employer-employee rate; and
- Extending coverage to newly hired federal civilian workers and all employees of nonprofit organizations, effective January 1, 1984.

Each of these proposals would increase revenues for the OASDI trust funds by more than for the federal budget, because of offsetting reductions in income tax receipts, and because employer contributions by federal agencies would not constitute new federal revenues.

Raise Payroll Tax Rates. The commission proposed raising OASDI payroll tax rates for employers and employees in 1984 from 5.4 percent each

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28. A retired couple with $22,000 of adjusted gross income and $8,400 in OASDI benefits--roughly the average retired couples' benefit--would pay some additional income taxes, for example. Because $22,000 plus $4,200 (50 percent of OASDI income) exceeds the threshold, this couple would add $600 ($22,000 + $4,200 - $25,000 = $1,200; $1,200 x 0.5 = $600) to its taxable income.

to 5.7 percent each (this increase would go into effect in 1985 under current law), and to 6.06 for 1988 and 1989 (see Table III-7). 29/ In addition, for 1984 only, the commission recommended enacting a refundable income tax credit for the employee's share only, which would equal the increase in OASDI taxes over the current law level. Thus, while the 1984 increase in payroll tax rates would increase Social Security revenues by $6.4 billion in 1984 and $2.3 in 1985, its impact on the federal budget deficit would be only about half as large.

TABLE III-7. OASDI TAX RATES UNDER CURRENT LAW AND UNDER COMMISSION RECOMMENDATIONS, 1984-1989 (In percents)

	Employers and Employees, Each		Self-Employed	
	Current Law	Commission Proposal	Current Law	Commission Proposal
1984	5.4	5.7	8.05	11.4
1985	5.7	5.7	8.55	11.4
1986	5.7	5.7	8.55	11.4
1987	5.7	5.7	8.55	11.4
1988	5.7	6.06	8.55	12.12
1989	5.7	6.06	8.55	12.12

Raise the Self-Employed Tax Rate to the Combined Employer-Employee Rate. The commission recommended that the self-employed be required to pay the combined employer-employee rate, but that one-half of the tax be allowed as a deductible business expense--a proposal identical to the option described earlier in this chapter. The estimated revenue increase presented here is slightly higher--$1.0 in 1984--than that shown earlier, however, because of the increases in tax rates recommended by the commission (see Table III-7).

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29. The tax rate increases to 6.2 percent in 1990 under current law.

Cover New Federal Workers and All Employees of Nonprofit Organizations. Extending Social Security coverage to new federal workers and all employees of nonprofit organizations would, when combined with the proposed tax rate increase, yield $12.9 billion in increased trust fund revenues over the 1984-1988 period. This proposal, which is similar to options discussed earlier in this chapter, would raise about $12.7 billion in new federal revenues over the same period. 30/

Other Recommendations Affecting OASDI Financing

A credit to the OASDI trust funds of $19.1 billion in 1983 was also proposed by the commission to compensate for gratuitous military service wage credits granted before 1983. The proposed lump-sum payment from the general fund would also include a reimbursement for Social Security checks--$0.8 billion--that have been issued but never redeemed. This transfer would provide the trust funds with additional resources when they most need them, but would have no impact on the federal deficit.

The commission also recommended a number of relatively small program changes that would have limited impacts both on Social Security financing and on the budget. 31/ For example, proposed increases in the benefits of certain types of recipients such as divorced spouses and disabled, widowed persons--predominantly women--would increase outlays by approximately one billion dollars over the next five years. On the other hand, the commission agreed that the benefits received by persons who are career workers in noncovered employment should be reduced, a change that would lower costs slightly.

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30. The estimate of the increase in federal revenues under this proposal includes the effects of extending the HI tax to employees of non-profit organizations, and also assumes that new federal employees would continue to make a 7 percent CSR contribution. The new revenues would be much lower, if, like most private pension plans, the supplementary CSR pension plan for new employees required a smaller employee contribution, or even no contribution.

31. Some recommendations, if enacted, could affect Social Security financing under some circumstances, but the CBO does not estimate any savings at this time. These include proposed changes in trust fund investment practices, and indexing benefits by the lower of wage increases or price increases, if trust fund balances are low.

Finally, the commission called for a reallocation of the total OASDI tax rate between the two funds to apportion the revenues more closely to the requirements of each fund. In addition, authority for OASDI to borrow from HI would be extended through 1987, but HI would not be allowed to borrow from the OASDI funds. 32/

Overall Effect of the Commission's Proposals on the Trust Funds and the Budget

As indicated in Table III-6, the CBO estimates that the commission's proposals would provide an additional $138 billion to the OASDI trust funds (including additional interest income on higher trust fund balances) over the 1983-1988 period. Thus, the commission's recommendations would yield about $67 billion more over the period than the CBO estimates would be required to maintain a minimum start-of-year balance of 12 percent, provided the economy's performance is not worse than currently forecast.

Table III-8 presents a comparison of the CBO estimates of OASDI trust fund ratios--start-of-year balances as a percent of annual outlays--over the 1983-1988 period under current law and under the commission's recommendations. In contrast to the current-law estimates, under which trust fund reserves are seen to decline steadily, the estimated effects of the commission's package show both OASDI and OASDI-HI balances starting to rise beginning in 1986. By the beginning of 1988, OASDI trust fund balances would reach 28.6 percent of annual outlays, thus providing the trust funds some margin for safety against adverse economic conditions. The estimates also indicate that these changes would not provide a large cushion in the next few years, however, which could result in further problems if the economic recovery is weaker, or occurs more slowly, than is now projected.

The impact of the commission's proposals on the overall budget deficit would be somewhat smaller than the effects on the trust funds (see Table III-9). Federal deficits for the 1984-1988 period would be reduced by a total of about $75 billion. The deficit-reducing effect of the proposals would increase each year, with the reductions ranging from $8.8 billion in 1985 to $26.5 billion in 1988. The proposed deficit reductions would be relatively small when compared to the overall deficit, however--amounting to only about 10 percent of the projected 1988 deficit, for example.

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32. Authority for the OASI trust fund to borrow from the DI and HI trust funds was granted by the 97th Congress but expired in December 1982.

TABLE III-8. OASDI AND OASDI-HI START-OF-YEAR BALANCES AS A PERCENT OF ANNUAL OUTLAYS UNDER CURRENT LAW AND COMMISSION PROPOSALS

	1984	1985	1986	1987	1988
Current Law					
OASDI	7.3	-2.6	-8.3	-11.6	-14.3
OASDI-HI	10.2	1.9	-3.2	-6.7	-11.1
Commission Recommendations					
OASDI	19.6	17.1	19.7	23.7	28.6
OASDI-HI	20.1	17.7	18.9	20.8	21.9

Removing the Social Security and Medicare Trust Funds from the Unified Budget

A majority of the NCSSR supported a recommendation to remove the OASI, DI, HI, and Supplementary Medical Insurance trust funds from the unified budget. Proponents of this change argue that, since Social Security is supported by earmarked taxes, it should not be considered as part of the overall federal budget process. On the other hand, enactment of this proposal would do nothing to change either the financial status of the trust funds or the overall size and economic impact of the federal government. Further, it would complicate budget accounting and would force analysts and policymakers to add these programs back into the budget totals when examining the size and impact of the total federal government.

Under current policy projections, the four Social Security trust funds will contribute to the unified budget deficit during the 1984-1988 period. If Social Security and Medicare were administered by "off-budget" agencies, the remaining budget would have deficits that ranged from $9 billion to $17 billion lower, because the excess of outlays over revenues for the trust funds would no longer be included.

In contrast, if the commission's proposals were enacted, OASDI trust fund revenues would exceed outlays throughout this period, so that moving

TABLE III-9. ESTIMATED IMPACT OF THE NATIONAL COMMISSION'S PROPOSALS ON UNIFIED BUDGET DEFICIT (In billions of dollars)

	1983	1984	1985	1986	1987	1988	Total 1983-1988
				Outlay Reductions			
Delay COLA from July to January a/	1.4	3.0	3.3	3.8	4.0	4.4	19.9
Miscellaneous Benefit Provisions	0	-0.1	-0.2	-0.3	-0.3	-0.4	-1.3
Total Outlay Reductions	1.4	2.9	3.1	3.5	3.7	4.0	18.6
				Revenue Increases			
Tax 50 Percent of OASDI Benefits b/	0	1.2	4.2	4.9	5.6	6.4	22.4
Increase Payroll Tax Rate with Refundable Tax Credit c/	0	6.5	-2.0	0	0	10.3	14.8
Increase Self-Employed Tax Rate with 50 Percent to be Deductible	0	0.5	1.5	1.4	1.5	1.7	6.6
Extend Coverage d/	0	1.2	2.0	2.5	3.0	4.0	12.7
Total Revenue Increases	0	9.4	5.7	8.8	10.1	22.5	56.5
Total Reductions in Unified Budget Deficit	1.4	12.3	8.8	12.3	13.8	26.5	75.1

NOTE: Preliminary CBO estimates. Components may not add to totals due to rounding. Negative numbers indicate outlay increases or revenue reductions.

a. Estimate includes increased SSI outlays resulting from the $30 increase in the amount of OASDI benefits not counted when determining SSI benefits, as well as increased outlays in other programs.

b. Estimate is based on a tax treatment similar to that used for Unemployment Insurance benefits.

c. Estimate also includes increased Railroad Retirement taxes.

d. Estimate includes effect of prohibiting the withdrawal of state and local governments from Social Security, and HI taxes for newly covered workers.

Social Security off budget could actually increase the deficit in the programs that remained on budget. Under either current law or the commission's plan, however, the deficit for the entire federal government--as opposed to the on-budget portion--would be unaffected by this proposal.

CONCLUDING COMMENTS

The Social Security system faces major financing problems in both the short and the long run, and some changes are imperative within the next year if benefits are to be paid in a timely fashion. Options that would improve Social Security trust fund balances would often, but not always, reduce the federal budget deficit as well. In particular, general revenue financing for some portion of Social Security benefits would improve trust fund balances, but it would leave the federal deficit unchanged. Other options, such as coverage of federal employees, would have varying effects on the trust funds and on the federal budget. (The budgetary impact of this option would depend on the modifications made in the Civil Service Retirement system.) In general, across-the-board options such as COLA reductions or payroll tax increases would do most to reduce the budget deficit while improving the short-run financial outlook for the trust funds.

CHAPTER IV. MEDICARE AND MEDICAID

Outlays for Medicare and Medicaid are projected to grow faster than the budget as a whole in coming years. The major pressure forcing up outlays is the rising cost of medical care. Until some way is found of containing medical care costs, these programs will continue to experience serious financing problems.

Medicare provides health insurance for 26 million persons aged 65 and over and nearly 3 million disabled persons. It consists of two programs--the payroll-tax-financed Hospital Insurance (HI) program and the voluntary Supplementary Medical Insurance (SMI) program that pays for physician services. The latter is financed by premiums (about one-quarter) and an appropriation from general revenues (about three-quarters). 1/

The Medicaid program provides matching funds to states to finance medical care for low-income persons who are in families with dependent children, or who are aged, blind, or disabled. 2/ Medicaid coverage varies by state, but always includes a broader array of services than Medicare. At present, 44 percent of its expenditures go for nursing home care and home health services.

BUDGET HISTORY AND PROJECTIONS

Both programs grew very rapidly throughout the 1970s and up to the present, although growth in Medicaid has slowed somewhat of late, principally because of program cuts by both federal and state governments.

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1. Except for payment of a deductible equal to one day's hospitalization--$304 at present--Medicare covers in full the first 60 days of hospitalization for a spell of illness. Significant coinsurance is required for longer stays. Limited skilled nursing facility and home health services are also covered, focused on recuperation from acute illness. After a $75 annual deductible, Medicare pays 80 percent of allowed charges for medical and health-related services and supplies, including payments to physicians and hospital outpatient facilities.

2. The federal share is based on state per capita income. In 1983, it will vary from 48 percent to 75 percent, with an average of 54 percent.

Growth in both programs is expected to moderate somewhat over the next few years as a result of budget cuts and other factors, but outlays will nevertheless grow significantly faster than the budget as a whole and cause serious financing problems for Medicare.

TABLE IV-1. FEDERAL OUTLAYS FOR MEDICARE AND MEDICAID
(In billions of dollars)

	Actual		Estimated	Baseline Projection				
Major Program	1980	1982	1983	1984	1985	1986	1987	1988
Medicare	35.0	50.4	57.1	65.4	74.0	85.2	98.7	112.1
Hospital Insurance	24.3	34.9	38.9	44.3	49.7	57.3	66.4	74.7
Supplementary Medical Insurance	10.7	15.6	18.2	21.1	24.3	27.9	32.3	37.3
Medicaid	14.0	17.4	19.4	21.3	24.1	26.2	28.7	31.4

Recent History, 1980-1982

Rapidly rising Medicare outlays continued during the 1980-1982 period, but growth in Medicaid slowed somewhat. Outlays for Medicare increased at an annual rate of 20.0 percent during this period, compared with a rate of 12.2 for the budget as a whole (see Table IV-1). Rapid increases in the cost of medical care were the principal cause, with growth in the eligible population and its aging explaining only two percentage points of the Medicare increase. Medicare outlays would have been even higher if not for program reductions enacted as part of the Omnibus Budget Reconciliation Act of 1981. 3/

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3. These included an increase in the deductible amounts in both the hospital and the physician parts of the program, a tightening of the limits on per diem reimbursements of hospitals for routine costs, and a reduction in the size of extra payments intended to offset the presumed higher nursing costs of Medicare patients (known as the nursing differential). These changes caused 1982 outlays to be about 1 percent lower than they would otherwise have been.

In contrast, outlays for Medicaid increased at an annual rate of only 11.6 percent during the period. While Medicaid faced the same rapid increases in the cost of medical care that Medicare did, other factors worked to reduce outlays, especially in 1982.

Federal budget cuts were perhaps the most important reason for slower Medicaid growth. Medicaid program changes made as part of the 1981 Reconciliation Act caused outlays to be 5 percent lower in 1982 than they would otherwise have been. The major cut was a 3 percent reduction in federal grants in 1982 from the amount otherwise payable (4 percent in 1983 and 4.5 percent in 1984), with provision for partial restoration in states meeting certain criteria. 4/ In addition, states were allowed substantially more discretion in the areas of hospital reimbursement and coverage of persons who qualify for Medicaid only when medical bills are subtracted from income (the medically needy). Changes in Aid to Families with Dependent Children (AFDC) in the 1981 act also reduced Medicaid outlays by reducing the number of persons automatically eligible for Medicaid.

In addition, state budget crises played a role in slowing growth in Medicaid. States have significant discretion in the areas of eligibility, benefits, and reimbursement, and numerous cuts were made in these areas at state initiative.

The Current Situation

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made additional cuts in Medicare and Medicaid, though in contrast to the previous year's law the new cuts were concentrated on Medicare. Medicare cuts will save $11.3 billion over the 1983-1985 period--or 5.4 percent of what outlays would have been. Since only $1.5 billion of the savings will be realized in 1983, however, outlays are estimated to increase 14.7 percent over 1982. 5/ Medicaid cuts were much smaller, totaling $1.0 billion--or 1.5 percent--over the three-year period.

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4. The criteria are high unemployment, effective hospital cost control programs, documented fraud and abuse reductions, or very low rates of increase in Medicaid spending.

5. These figures exclude accounting savings from a temporary delay in Medicare's interim payments to some hospitals. In addition, they exclude the impact of the increase in SMI premiums, which changes the financing of that program but does not diminish program spending.

Most of the Medicare reductions were in reimbursements to hospitals. A major step was taken toward changing the reimbursement system from a retrospective cost-based one to a prospective one. 6/ Targets for rates of growth in costs per admission from 1982 levels were established for 1983, 1984, and 1985, with bonuses to be paid to hospitals below their targets and penalties for hospitals above their targets. In addition, limits on routine costs were replaced by limits on total operating costs per admission. Outlay reductions from this and other hospital reimbursement changes will amount to $8.5 billion over the 1983-1985 period.

Some of the other program changes in Medicare included in TEFRA also reflect significant changes in policy. Medicare benefits were made secondary to employment-based private insurance for employed beneficiaries aged 65-69. Reimbursement for radiologists and pathologists was reduced from 100 percent of reasonable charges to 80 percent. Premiums for SMI were increased, and federal employees were required to pay the HI tax. Outlay reductions and revenue increases from Medicare changes other than hospital reimbursement will total $6.4 billion over 1983-1985.

Few program changes were enacted in Medicaid during 1982. State options to require copayments by recipients were expanded, and states were given the option to place liens on the homes of institutionalized recipients so that benefits could be repaid if a recipient died while institutionalized. Medicaid savings from TEFRA are expected to amount to $0.9 billion over 1983-1985.

Baseline Projections, 1984-1988

Despite the program cuts enacted in 1981 and 1982, Medicare outlays are projected to grow rapidly during the 1984-1988 period, principally because of rising medical care costs. The average rate of increase is projected to be 14.4 percent per year. 7/

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6. Under prospective reimbursement, the rate of payment is set in advance and not based on an individual hospital's actual costs for that year, thereby requiring hospitals to share the risk of increasing costs.

7. The baseline projection assumes that the limits on hospital reimbursement increases (the source of an important part of the reimbursement savings) expire after 1985 and are not renewed. But extension of the targets or substitution of a prospective payment system are distinct possibilities. How stringent any extension or substitute would be, with

Rising baseline outlays for Medicare are a problem both for the size of the budget deficit and for the solvency of the HI trust fund. Under the projections, Medicare will constitute 10.0 percent of the budget by 1988 and the HI trust fund will be exhausted by late 1987. 8/ Unlike the financing problems of the other Social Security trust funds, however, HI deficits are not temporary but grow rapidly. By 1995, annual outlays will exceed payroll tax revenues by about two-thirds. Very large reductions in outlays or increases in revenues to the trust fund, or a combination of both, will be required to maintain solvency.

Medicaid outlays are also expected to increase more rapidly than federal spending as a whole, but at a slower rate than Medicare. From 1983 through 1988, a 10.0 percent annual rate is projected. A slight decline in the AFDC population, further state-level program changes in response to increased flexibility provided in the 1981 Reconciliation Act and TEFRA, and continuing state fiscal pressures are behind the projection of more moderate growth rates.

DEFICIT REDUCTION STRATEGIES

Two broad budget reduction strategies are available in Medicare and Medicaid. One would involve a continuation of the strategy employed thus far--changes in the programs' benefit structure and methods by which providers are reimbursed. The second strategy would involve legislation aimed at the medical care system as a whole. Since general medical care cost increases are the major source of increases in outlays in these programs, policies to slow them may be the only long-term option to reduce federal outlays without substantially reducing benefits.

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its corresponding budget implications, is impossible to predict. A critical factor will be the degree to which hospitals reduce costs in response to the Medicare reimbursement incentives. Cost reductions by hospitals during this period would create opportunities for additional reimbursement reductions in the future.

8. If the reimbursement changes included in TEFRA were extended, so that the 1985 level of savings as a percentage of hospital outlays was maintained, HI's projected insolvency would be postponed by about one year.

PROGRAM CHANGES

Most of the specific program changes discussed below are in Medicare. Given the Congress's 1981 decision to have the states take the initiative in reducing Medicaid costs through increased financial incentives and greater flexibility to make program changes, and the lack of financial resources available to the population served, few options other than additional transfers of responsibility to the states have the potential to reduce federal outlays further without sacrificing Medicaid's goal of improved access to medical care by the poor. The Medicare program changes discussed are grouped as follows:

- Increased beneficiary cost sharing,
- Prospective reimbursement for hospitals, and
- Changes in physician reimbursement.

Increase Beneficiary Cost-Sharing

Changing the structure of Medicare benefits to increase cost-sharing by beneficiaries represents one major option to reduce outlays. Greater cost-sharing could achieve savings in two ways: directly, as a result of increasing the financial responsibility of beneficiaries for medical costs; and indirectly, by discouraging the use of health care services.

The benefit structure of Medicare could be changed in a number of ways to increase cost-sharing by beneficiaries. Some of these ways would involve patient liability for some portion of each medical event. For example, coinsurance (a percentage of the charge) or copayments (a set dollar amount per event) could be assessed against days in the hospital. Finally, payment of premiums for health coverage might also be considered a form of cost-sharing.

Another change that could be implemented in conjunction with greater cost-sharing would be an upper bound on the amount of Medicare out-of-pocket liability that any one beneficiary would be required to pay. To the extent that such changes would provide catastrophic protection to beneficiaries, the latter might be better able to absorb modest increases in yearly medical costs.

A limit on Medicare out-of-pocket expenses set high enough to avoid actually increasing outlays, however, might not provide sufficient relief for moderate-income Medicare enrollees. Although elderly and disabled persons with the lowest incomes may receive aid through Medicaid, coverage is not universal for all persons with low incomes, and those at slightly higher income levels are largely ineligible. For example, a $3,000 limit on Medicare out-of-pocket expenses would likely be considered too high for someone with $8,000 of income and a high probability of expenses for uncovered services such as drugs. One way to limit the conflict between burdens on low- and moderate-income enrollees and Medicare outlay savings would be to vary the cap on out-of-pocket costs by income.

Expand Hospital Coinsurance. Under current provisions of the Medicare Hospital Insurance program, patients pay a deductible equal to the average cost of one day's hospitalization--$304 in 1983. Medicare beneficiaries pay coinsurance charges (generally 25 percent) only after 60 days of hospitalization for a particular spell of illness. Consequently, only about 0.6 percent of enrollees pay hospital coinsurance in any year.

In addition to the first-day deductible, beneficiaries could be required to pay 10 percent of the deductible amount for each of the next 29 days of a hospital stay in each calendar year--about $35 per day in 1984. For stays beyond 30 days, Medicare would cover all charges, thus improving coverage for participants with extended hospital stays. This option implicitly sets a maximum yearly out-of-pocket individual liability for hospital care of $1,373 in 1984. The Medicaid program would continue to pay the coinsurance costs for those elderly and disabled persons enrolled in both programs. Enactment of this proposal would reduce federal outlays by $16.5 billion over the next five years (see Table IV-2), but state outlays for Medicaid would increase by $840 million.

The option would increase incentives to avoid unnecessary hospital use. But with about 70 percent of Medicare beneficiaries covered by either private supplemental insurance or Medicaid, changes in incentives to conserve on the use of medical services would be limited.

A problem with the option is that out-of-pocket costs would rise substantially for the majority of those elderly and disabled who are hospitalized. Since physicians' fees are already subject to coinsurance under Medicare, the burden of an illness requiring hospitalization could rise to well over $2,000. Moreover, persons ineligible for Medicaid who could not afford the cost-sharing might forgo some needed medical care.

One modification of a hospital coinsurance option would be a cap of $2,000 on total out-of-pocket costs from both HI and SMI in lieu of the 30 day limit on coinsurance for those with incomes below $20,000. Individuals with incomes below this maximum and with high medical expenditures could apply for special status that would entitle them to the limit. Above that

TABLE IV-2. BUDGET SAVINGS FROM PROGRAM CHANGES IN MEDICARE AND MEDICAID (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Medicare						
Increase Beneficiary Cost-Sharing						
Expand Hospital Coinsurance Days 2-30 a/						
Budget Authority	-190	-520	-800	-1,070	-1,370	-3,950
Outlays	1,980	3,010	3,400	3,820	4,290	16,490
Expand Hospital Coinsurance with Cap on Out-of-Pocket Costs for Some a/						
Budget Authority	-70	-240	-400	-550	-720	-1,980
Outlays	1,190	1,820	2,050	2,320	2,610	9,990
Increase SMI Premiums a/						
Budget Authority	900	1,120	1,700	2,460	3,370	9,550
Outlays	900	1,120	1,700	2,460	3,370	9,550
Increase SMI Premiums for High-Income Families Only						
Budget Authority	240	300	450	650	890	2,530
Outlays	240	300	450	650	890	2,530
Tax the Premiums for Supplemental Coverage b/	2,390	3,610	4,160	4,820	5,470	20,450

(continued)

TABLE IV-2. (Continued)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Move to Prospective Hospital Reimbursement						
Replace Reimbursement Limits in TEFRA with Prospective Reimbursement						
Budget Authority	--	--	-80	-300	-580	-960
Outlays	--	--	2,140	4,100	4,610	10,850
Change Physician Reimbursement						
Limit Reasonable Charge Growth						
Budget Authority	40	260	670	1,200	1,830	4,000
Outlays	10	190	590	1,100	1,730	3,620
Adopt Fee Schedules for Surgical Procedures						
Budget Authority	170	700	810	940	1,100	3,720
Outlays	180	680	790	920	1,070	3,640
Medicaid						
Extend Cuts in Matching Grants for Medicaid						
Budget Authority	--	870	660	840	1,040	3,410
Outlays	--	870	660	840	1,040	3,410

a. Savings estimates reflect the concurrent increase in federal Medicaid expenditures.

b. Savings are a combination of outlay reductions and revenue increases. Budget authority estimates are not available.

income limit, beneficiaries would face 10 percent coinsurance on each hospital day after the first. In this case, however, the number of enrollees affected in any year by hospital coinsurance and therefore seeking eligibility for the cap would be relatively small--probably less than 4 percent of all beneficiaries. This option would result in federal savings from coinsurance of $10.0 billion over the 1984-1988 period.

Limiting patients' liability for cost sharing would protect patients from expenses that could wipe out much or all of a family's savings. On the other hand, there are a number of practical difficulties with income-tested benefits including administrative complexities, the arbitrariness of a single cut-off line for granting a limit on liability, and philosophical opposition to subjecting receipt of Medicare to a means test.

A third modification of the hospital coinsurance option could be introduced to give patients incentives to use less expensive hospitals. Instead of reimbursement based on a hospital's own costs, Medicare could reimburse each hospital at a set rate. The rate would compensate providers for, on average, 90 percent of the reasonable hospital costs for a particular area. Patients would be liable for the remainder, with the restriction that no hospital could charge more per day than its own calculated amount of reasonable costs. Moreover, patients in low-cost hospitals would pay less than $35 in coinsurance per day and, in some cases, no coinsurance at all. Savings in federal outlays under this modification would be somewhat higher than if coinsurance was the same at each hospital, since increased competition among hospitals would lower costs and result in somewhat lower reimbursements.

Increase SMI Premiums. Premium receipts have covered a declining percentage of SMI costs each year--falling from 50 percent of all costs in 1972 to 25 percent in 1982. This decline in the enrollees' contribution has resulted because the formula for calculating premium increases was limited to the rate of growth of Social Security benefits, which is tied to the Consumer Price Index rather than to the faster-increasing per capita cost of SMI. Changes passed in TEFRA will stabilize these premiums at 25 percent of the incurred SMI costs for an aged enrollee through June 30, 1985. After that date, the premium calculation is scheduled to be limited again to the rate of growth of Social Security benefits.

If the premium was set so that participants would pay 30 percent of incurred costs per aged enrollee from October 1, 1983, federal savings would total $0.9 billion in 1984 and $9.6 billion over the 1984-1988 period. State outlays for Medicaid, which often pays the premiums for its Medicare-eligible recipients, would increase by about 6.4 percent of that amount, however. Premium costs would rise to an estimated $16.20 per month on October 1, 1983, instead of the scheduled $13.50.

This option would effectively reduce a federal subsidy that has grown to be larger than originally planned. It would not affect the poorest of the elderly and disabled since they are likely to be eligible for Medicaid.

On the other hand, some elderly and disabled persons would still find the increased premiums burdensome, with medical costs consuming an ever-increasing share of their budgets. Some might drop SMI coverage and either do without medical care or turn to sources of free or reduced-cost care, increasing demands on local governments.

To provide relief for moderate-income families, this option could be modified to limit the increase to persons with incomes above a certain level--$20,000 per year, for example. While Medicare savings would fall by 68 percent, the increase would occur only for those elderly and disabled for whom the increased costs are less of a burden. The practical difficulties outlined in the discussion of limiting liability for hospital coinsurance would apply, however, and might be more severe, since all enrollees above the income cutoff--rather than just the 20 percent admitted to a hospital each year--would have to be considered.

Tax the Premiums for Supplemental Coverage. In order to reduce their out-of-pocket payments for deductibles and coinsurance, approximately 58 percent of Medicare enrollees purchase (or receive from former employers) private coverage to supplement Medicare (often called "Medigap"). The plans vary widely, but often pay all the cost-sharing required by Medicare.

By increasing "first-dollar" coverage, Medigap coverage induces enrollees to use services at a higher rate. First-dollar coverage causes patients (and their physicians) to be less sensitive to whether services are needed and to whether the price is too high. This might not be a problem, except that Medigap premiums are heavily subsidized by Medicare. When additional services are used as a result of extra first-dollar coverage, Medicare pays most of their cost (for example, 80 percent of physicians' reasonable charges and the full costs of the second through sixtieth days of hospitalization during a spell of illness). This not only costs Medicare a lot of money--$3.2 billion in 1984--but means that some who purchase Medigap plans do so only because of this subsidy from Medicare.

Imposing a premium tax of 30 percent on Medigap policies that pay any part of the first $1,000 of Medicare cost-sharing would recoup the extra federal outlays arising from supplemental coverage. Federal savings would accrue from both the premium tax receipts and from a reduction in health care use by those who would drop Medigap coverage because of the increase in its cost. 9/ If effective January 1, 1984, savings would total $2.4 billion in 1984 and $20.5 billion over the 1984-1988 period.

This option would lead to more equal government aid across all participants by requiring those with Medigap coverage to bear the additional costs they impose on the Medicare system, yet would not affect insurance protection for unusually large health costs. Moreover, most of those elderly and disabled persons with the lowest incomes would be unaffected, since Medicaid provides their supplemental coverage.

On the other hand, the premium tax would increase the cost of Medigap policies and therefore discourage their purchase. Some who would otherwise have purchased supplemental coverage would face difficulties in meeting out-of-pocket costs during a year of unusually high medical expenditures. In addition, since the federal government subsidizes the cost of employment-based health insurance through the tax system (see Appendix A), removing only the Medigap subsidy might be perceived as unfair.

Move to Medicare Prospective Reimbursement of Hospitals by Medicare

In TEFRA, the Congress made some important changes in Medicare reimbursement of hospitals. It expanded existing limits on routine costs to include ancillary costs as well, and established temporary limits on annual increases in hospital reimbursement per case. The conference report indicated that these were interim steps in the direction of a prospective reimbursement system in which payment rates would be established in advance, and hospitals would gain or lose depending on whether costs were below or above these rates. 10/

The Congress could move further toward a prospective reimbursement system for Medicare by paying hospitals a fixed amount per admission, with the amount varying according to the diagnosis-related group (DRG) into which the patient is classified and according to local wage rates. The Secretary of Health and Human Services suggested such an approach in a December 1982 report to the Congress. 11/

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9. Revenues could be dedicated to the trust fund, which finances Medicare hospital coverage.

10. Tax Equity and Fiscal Responsibility Act of 1982, H. Rept. 97-760, 97 Cong., 2 sess. (1982).

11. Richard S. Schweiker, Report to Congress: Hospital Prospective Payment for Medicare (December 1982).

The advantages of such a change from current policies governed by TEFRA would include increased incentives for hospitals to contain costs and an end to using actual costs of individual hospitals during a base period. Opportunities for low-cost hospitals to receive bonuses would be much greater than under current law, which restricts bonuses to 5 percent of target costs, so more hospitals would have incentives to reduce costs. Since hospital reimbursement would not depend on actual hospital costs during a base period, the phenomenon of those hospitals that have long been efficient being inadvertently penalized would be avoided.

On the other hand, the DRG classification system has not been extensively tested and may not yet be accurate enough to serve as the sole basis for reimbursement. Inadequate homogeneity within DRGs could result in large windfall gains and losses to individual hospitals.

Medicare could still move further to prospective reimbursement without possible premature overdependence on DRGs by combining the approach with that of basing rates on actual hospital costs during a base period. The DRG portion of the combined formula could be given greater weight over time as the methodology and the data were refined and as actual costs in a base year became less relevant to the present.

Further movement toward a prospective reimbursement system would be unlikely to lead to significant budget savings until 1986, when the phase-out of the growth rate limits under current law begins. The baseline already reflects substantial reimbursement reductions anticipated under TEFRA, especially in 1985. For a prospective reimbursement system to achieve further budget savings, the prospective rate would have to be set lower than the TEFRA limits, which already are tightening over time. If a prospective reimbursement plan reduced reimbursements relative to the pre-TEFRA baseline by the same 9.1 percent as is now projected under TEFRA for 1985, Medicare savings would amount to $2.1 billion in 1986 and $10.9 billion over the 1986-1988 period.

A critical question in hospital reimbursement policy is whether prospective reimbursement should apply only to Medicare and Medicaid, or whether it should apply to all payers. Many worry about the ability of hospitals to avoid some of the consequences of reduced Medicare reimbursement by raising charges to private payers instead of reducing costs. This issue of program change versus medical care system reform is discussed below.

Change Physician Reimbursement

Currently, the level of reimbursement received by a physician under Part B of Medicare is based on the calculation of "reasonable" charges. This allowable charge may not exceed the lowest of the physician's actual charge, his or her customary charge for that service, or the applicable prevailing charge in the locality. Since 1976, annual increases in the prevailing charge for physicians' services have been limited by an economic index that reflects changes in their operating expenses and earnings levels throughout the economy. Physicians who wish to charge their patients amounts in excess of reasonable charges may do so, however, by refusing to accept "assignment." 12/

Options for cutting physician reimbursements could be directed at reasonable charges for all services or at those for particular services or types of physicians. In all of these options, however, the current ability of physicians to recoup any reduction in Medicare reimbursements by passing on additional charges to beneficiaries is an overriding concern. As long as physicians are permitted to make additional charges to patients, increased savings from reduced reimbursements may be achieved only at the expense of higher costs for beneficiaries.

Two options for changing physician reimbursement are considered in detail below. The first would limit growth in reasonable charges. The second would begin to move Medicare to a system of fee schedules that would allow changes in the relative level of reimbursements across types of services.

Limit Reasonable Charge Growth. Outlays for physician reimbursement could be reduced by restricting the growth rate in allowable charges to the growth in the overall Consumer Price Index (CPI). Though small in 1984, savings would total $3.6 billion over the next five years since the CPI is projected to grow at a lower rate than physicians' fees.

Not all of the costs of this proposal would be borne by the physicians, however. Those who do not accept assignment could raise their extra charges on beneficiaries. Moreover, physicians accepting the allowable charges could respond by increasing the number of services provided, thereby offsetting some of the Medicare savings.

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12. In Medicare, accepting assignment means billing the program for reasonable charges and collecting from the patient only the required deductibles and coinsurance. Physicians unwilling to do this must bill the patient, who in turn submits a claim to Medicare.

An alternative approach to help minimize the amount of additional charges passed on to beneficiaries would be to allow greater growth in allowed charges to physicians accepting assignment. This procedure would benefit those patients whose physicians respond to the incentive for higher reimbursements and decide to accept assignment. By varying the amount of reimbursement according to whether physicians accept assignment, those physicians deciding not to would have to pass considerable costs on to patients if revenues were to be maintained. On the other hand, if many of the physicians currently not accepting assignment continued not to, and made increased additional charges to patients, an important portion of the Medicare outlay reductions would be obtained at the expense of beneficiaries, and the arguments for and against coinsurance would apply.

Adopt Fee Schedules for Surgical Procedures. Medicare could begin to move to a system of fee schedules--that is, a set amount of reimbursement for a particular service--in place of the current system of reasonable charges. Some variation in fees could be allowed, for example, by region or by the location where the service is performed (for example, office, hospital, or clinic). Fees could be based on studies of relative value or other indicators of the time and skill necessary to perform the service, and additional factors could be designed to encourage procedures and locations that are relatively cost-effective.

Since such a broad change in reimbursement would likely require considerable study and negotiation, fee schedules could be incrementally introduced, beginning with surgical procedures. Physicians would be offered a fee for a particular procedure--assuming no complications--that would be known in advance. Since many consider fees for surgery relatively high compared with those for other physician services, the schedule could be set so that allowed charges for surgical procedures were reduced by 10 percent. This would reduce federal outlays by $180 million in 1984 and $3.6 billion over the next five years. Use of such fee schedules could also be coupled with the restriction that physicians accept assignment.

Fee schedules would allow more control over reimbursements by Medicare. No longer would reimbursements necessarily be tied to relationships among types of services reflecting history rather than current relative difficulty. Fee schedules could more readily be adjusted to reflect changes in technology, for example. They could favor, relative to current law, surgery done on an outpatient basis and those procedures deemed relatively cost-effective. As fee schedules were expanded in other areas, the levels could also be set to encourage other changes such as movement of physicians into specialties with traditionally low reimbursement levels--primary care, for example.

Since substitution of fee schedules for the current method of reimbursement for physician services would mark a change from a passive stance on the part of Medicare to more active intervention in the physician services market, many physicians might resist such changes. If coupled with mandatory assignment, some physicians might cease treating Medicare patients. If this happened, beneficiaries would have to balance the more limited choice of physicians with lower out-of-pocket liabilities.

Extend Cuts in Matching Grants for Medicaid

Reductions in matching grants for states enacted in the Reconciliation Act of 1981 expire after fiscal year 1984. Extending them indefinitely would not affect 1984 outlays, but would lower outlays by $3.4 billion from the baseline projection over the following four years.

A notable feature of this method to reduce federal outlays for Medicaid is that state discretion would be maximized. States could decide whether to replace the lost federal grants with their own funds, or, if program cuts were to be made instead, states could choose specific program changes that they believed would depart the least from the goals of the Medicaid program.

Continuation of this shift of financial responsibility to the states may not be desirable, however, especially given the severe effects that the recession has had on the budgets of some states. Some have suggested revising matching rates so as better to reflect interstate variation in fiscal capacity.

MEDICAL CARE SYSTEM CHANGES

Since the major source of rising outlays for Medicare and Medicaid is rising medical care costs, policy changes that would affect the medical care system in other ways than through Medicare/Medicaid may be necessary. These include policies that would encourage competition in the market for medical care, and policies that would increase government regulation of this market. At present, neither competition nor regulation is particularly strong, and spending on medical care is relatively unconstrained.

Toward More Competition. A competitive strategy would involve encouraging increased use of Health Maintenance Organizations (HMOs) and similar organizations for the delivery of medical services, and--for those persons retaining traditional health insurance--encouraging larger deductible amounts and more coinsurance. Those who favor such economic incentives believe they would result in more judicious use of medical services and, therefore, lower prices. Critics are skeptical about the benefits of this strategy, and about whether it would adequately protect the interests of poor families.

The most important federal measure for increasing competition in medical care would be a change in the tax treatment of employer-paid health insurance. Current policies provide an incentive to shift employee compensation from cash toward health insurance in order to save on taxes. Removal of this tax subsidy, at least for the last dollars contributed by an employer, would increase the use of cost-sharing provisions in insurance policies and spur experimentation with other methods of containing costs such as preferred provider restrictions, where the policyholder is rewarded for restricting himself to providers identified as low-cost. Chapter X on revenues discusses in more detail an option to place a limit on the magnitude of this tax subsidy.

Toward More Regulation. A regulatory strategy would involve increased control by government over resources going to various providers and the allocation of services to different patients. One frequently discussed regulatory tool is prospective reimbursement of hospitals, applied to all payers. It would be more effective in encouraging cost reduction than the Medicare-only option discussed above because hospitals would not be able to shift any of the reimbursement reduction to other payers. After a transitional period, hospitals would reduce the growth in their costs in order to conform to the limited growth in reimbursements. Indeed, the seven states having hospital cost control programs that conform to the definition in the 1981 Reconciliation Act have held increases in per capita inpatient expenses over the 1976-1981 period to 11 percent per year, compared with increases of 14 percent in all other states.

Critics of this type of regulation point to the possibility of errors by the regulators. For example, a hospital's rate could be inadvertently set too low, causing financial problems. In addition, costly distortions could arise through attempts to evade the regulations, such as by increasing admission rates for patients not seriously ill. While each of these problems could affect a Medicare-only system as well, they would be more severe when all payers are included.

An all-payers approach to prospective payment of hospitals could be administered either federally or at the state level. A state-level system would provide a wider range of experience for future development, as well as an ability to adapt the program to local conditions. On the other hand, an important portion of hospital costs is paid by the federal government, so that state incentives alone might be insufficient.

A regulatory approach need not be confined to prospective payment. Limitation of hospital capital spending through health planning has been pursued in some states, though with mixed results. Physician fees could be limited by fee schedules applied to all payers. This option has received only limited consideration in the United States, but is in use in many other Western countries.

CONCLUDING COMMENTS

Rising outlays for Medicare and Medicaid will continue to put pressure on the federal budget and the HI trust fund for some time. Outlays are increasing because of rising medical care costs and the aging of the population, and neither are likely to diminish soon. The long-term solvency of the HI trust fund will require either substantial revenue increases or reductions in outlays far greater than under the program changes being considered today--or both. Program changes can reduce outlays in the short run, but their limited impact on medical care costs means that the critical decisions on medical care and its financing are only being delayed by a few years. Indeed, the projected exhaustion of the HI trust fund may serve to focus more attention on the fundamental issue of rising medical care costs.

CHAPTER V. OTHER ENTITLEMENT PROGRAMS

Most of the programs categorized as "other entitlements" provide direct benefits to persons or families who qualify because their incomes are very low or because they are unemployed, disabled, or old. 1/ These programs are entitlements, in the sense that all individuals who meet the qualifying criteria may receive benefits, and program outlays depend on the number of eligible individuals who apply. Even though large cuts were made in most of these programs in 1981, expenditures in this category grew by about 15 percent between 1980 and 1982, largely because of the increase in the unemployment rate. In fact, growth in outlays for unemployment benefits accounted for almost two-thirds of the total growth in this area.

Two other programs included in this category--General Revenue Sharing (GRS) and Title XX Social Services--provide payments for states and local governments rather than for individuals. They are capped entitlements, whose spending levels are determined in the annual budget process. Outlays for both of these programs have fallen substantially since 1980.

Benefits for Individuals

The programs providing benefits for individuals that are discussed in this chapter fall into three groups:

- Non-means-tested programs, in which persons qualify for benefits for reasons other than income level--for example, because they are unemployed or disabled.

- Means-tested programs, in which low income is a major qualifying criterion, although other characteristics, such as age, disability, or the presence of a dependent child, may also be important in determining eligibility for benefits.

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1. Entitlement programs examined elsewhere in this paper include Social Security, discussed in Chapter II; Medicare and Medicaid, discussed in Chapter IV; and pension and disability benefits for federal workers, discussed in Chapter VIII. Military retirement benefits are discussed in Chapter II, although Veterans' Compensation is discussed in this chapter. Farm price support programs are discussed in Chapter VI.

- Partially means-tested programs, in which benefits vary with a measure of need, but which extend benefits to some higher-income households.

Non-Means-Tested Benefit Programs. This category includes two programs, Unemployment Insurance (UI) and Trade Adjustment Assistance (TAA), that provide benefits for unemployed workers, and three programs, Veterans' Compensation, Black Lung, and Railroad Retirement, that provide disability and retirement benefits to specific groups of workers, either as a supplement to or as a substitute for Social Security benefits. Three of these programs--UI, Black Lung, and Railroad Retirement--are funded through trust funds, which are financed through earmarked taxes paid by employers and, in some cases, workers.

Means-Tested Benefit Programs. These programs include Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), Veterans' Pensions, and Food Stamps. The first three of these provide cash assistance payments to low-income families and individuals who meet the eligibility criteria, which include characteristics such as presence of a dependent child, old age, or veterans' status in addition to low income. The Food Stamp program provides coupons for purchasing food. In the SSI program, most states provide supplementary benefits in addition to the federal SSI benefit. In the AFDC program, federal payments take the form of grants to the states, which are then passed on, in conjunction with matching state funds, to eligible individuals.

Partially Means-Tested Benefit Programs. This category includes the Guaranteed Student Loan (GSL) program, which provides loan subsidies and guarantees for postsecondary students, and the child nutrition programs, which provide subsidized school lunches, school breakfasts, and food supplements for school children. Federal GSL payments go directly to financial institutions providing loans, while child nutrition funds for the most part take the form of federal grants to school districts.

Public Services Grants for States and Localities

The General Revenue Sharing program and the Title XX Social Services program provide grants to states and localities. 2/ GRS provides

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2. As discussed above, the AFDC and child nutrition programs also provide grants to states and localities, but in these two programs federal expenditures are made on behalf of eligible individuals, to whom the funds ultimately go.

general-purpose funds for local jurisdictions, and Title XX provides funds for social services like day care, home help for the handicapped and the elderly, and family planning and counseling. Both of these programs were designed as entitlements for state and local governments, with the shares of funds going to specific governments based on formulas that take into account factors such as the jurisdictions' relative income, population, and tax effort. Unlike most of the entitlement programs for individuals, however, spending under each of these programs is capped, and does not vary automatically with aggregate changes in the factors included in the allocation formulas. The Congress sets the level of the cap in the appropriations process. 3/

BUDGET HISTORY AND PROJECTIONS

In 1982, spending for these entitlement programs came to $87 billion, or about 12 percent of the budget (see Table V-1). The Unemployment Insurance program accounted for more than one-fourth of this total, and the three largest programs--UI, Food Stamps, and Veterans' Compensation--accounted for more than half. Outlays for these programs generally depend, at least to some extent, on the state of the economy; if the unemployment rate falls as projected in coming years, outlays for most will grow little, and in some cases will decline.

Recent History, 1980-1982

Rising rates of unemployment caused total expenditures for these entitlement programs to grow by about 15 percent between 1980 and 1982. Almost two-thirds of this increase was accounted for by higher outlays for unemployment benefits, which grew by about 50 percent. High rates of unemployment probably also indirectly increased outlays for other benefit programs such as Food Stamps and AFDC.

Outlay levels for these programs in 1982 were considerably lower, however, than they would have been if they had been based on 1980 law. Cuts ranging from 10 to 20 percent of projected outlays, and affecting both benefit levels and program eligibility, were enacted in 1981 in all of the means-tested individual-assistance programs except SSI and Veterans' Pensions. Reductions of a similar or greater magnitude were also enacted in Guaranteed Student Loans, child nutrition programs, Unemployment Insurance, Trade Adjustment Assistance, and Title XX Social Services. Appropriations for General Revenue Sharing were not cut in 1981, but were

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3. The cap for Title XX is actually specified in the Social Security Act, and changes in the cap may require an amendment to that act.

TABLE V-1. FEDERAL OUTLAYS FOR "OTHER ENTITLEMENT" PROGRAMS (In billions of dollars)

	Actual		Estimated	Baseline Projection				
Major Program	1980	1982	1983	1984	1985	1986	1987	1988
Benefits for Individuals								
Non-Means-Tested Programs								
Unemployment Insurance	16.4	24.3	33.0	27.8	26.5	26.1	25.9	25.6
Trade Adjustment Assistance	1.7	0.1	0.1	0.1	a/	a/	a/	a/
Veterans' Compensation	7.4	9.3	9.9	10.2	10.6	10.9	11.2	11.3
Black Lung	1.8	2.0	1.8	1.8	1.8	1.8	1.8	1.8
Railroad Retirement b/	4.7	5.3	5.7	5.9	6.0	6.2	6.3	6.4
Means-Tested Programs								
AFDC c/	7.3	8.0	8.1	8.4	8.5	8.8	9.1	9.5
SSI d/	6.4	7.7	8.6	7.4	8.1	8.4	8.6	9.6
Veterans' Pensions	3.6	3.9	3.8	3.7	3.7	3.6	3.5	3.5
Food Stamps e/	9.1	11.0	12.4	12.2	12.5	13.1	13.5	13.8
Partially Means-Tested Programs f/								
Guaranteed Student Loans	1.4	3.0	2.5	2.6	2.9	2.8	2.6	2.5
Child Nutrition	4.7	4.4	4.6	4.9	5.2	5.4	5.7	6.0
Public Service Grants for States and Localities								
General Revenue Sharing	6.9	4.6	4.6	4.7	5.0	5.2	5.5	5.7
Title XX Social Services	2.8	2.6	2.5	2.5	2.6	2.7	2.7	2.7
Total	75.5	87.4	97.6	92.2	93.4	95.0	96.4	98.4

a. Less than $50 million.

b. About 60 percent of outlays for Railroad Retirement provide Social Security benefits for retired railroad workers.

c. AFDC estimates include the Child Support Enforcement program.

d. Fiscal years 1983 and 1988 include 13 months of benefits; fiscal year 1984 includes 11 months.

e. Estimates include nutrition assistance for Puerto Rico.

f. These programs, while partially means-tested, do serve some higher-income households.

reduced by one-third in 1980 when payments to states were eliminated. SSI and the programs for veterans are the only programs included in this chapter that were exempt from major changes over the last two years.

The Current Situation

Although the Administration's 1983 budget included several proposed cuts, especially in the means-tested public assistance programs, few of these were implemented. A further reduction of about 5 percent was enacted in the Food Stamp program, and smaller reductions were made in veterans' programs, AFDC, and SSI. Outlays for this category as a whole in 1983 will depend largely on the state of the economy, and especially on the unemployment rate. If the unemployment rate in 1983 averages about 10.6 percent, as is now projected, total 1983 outlays for these programs will be about $98 billion.

Baseline Projections, 1984-1988

Total outlays for these programs are projected to grow very little in the 1984-1988 period. Outlays in 1984 will be about $6 billion lower than those for 1983, if unemployment falls as projected. Most of the decline in outlays will be accounted for by falling unemployment insurance payments. UI outlays are projected to continue to decline through 1988, although at a slower rate. Outlays for most of the other programs included in this chapter are projected to remain stable or to grow very slowly over the next five years, somewhat offsetting the projected decline in UI. Since in general the rate of growth is projected to be less than the rate of inflation, however, outlays in these programs will decline in real terms under current law.

DEFICIT REDUCTION STRATEGIES

This chapter examines several types of entitlement programs, concentrating on those that have not been heavily cut so far. Additional reductions in those that have already experienced large cuts might be difficult to achieve without major changes in the federal government's aims and responsibilities in these areas. Further, additional reductions in unemployment benefits and in assistance for low-income families and individuals might be undesirable in a period of high unemployment and economic recession, both because of their potentially adverse effects on the economy and because they might create substantial hardships for many individuals.

The specific changes discussed in this chapter have been organized into four major strategies, of which two would increase revenues and two would reduce outlays relative to current law. The revenue-increasing strategies are:

- Provide additional revenues for programs financed through trust funds; and
- Tax certain benefits for individuals.

The strategies that would reduce outlays are:

- Increase the targeting of program aid on the neediest; and
- Reduce inconsistencies among different programs that affect the same population.

STRATEGIES TO INCREASE REVENUES

This section examines the two strategies for increasing revenues. The various options considered under these strategies are summarized in Table V-2.

Provide Additional Revenues for Programs Financed Through Trust Funds

Several programs, including UI, Railroad Retirement, and Black Lung, are funded through trust funds, which, like the Social Security trust funds, have recently experienced some problems of solvency, largely resulting from the continuing economic recession. Employers' contributions for both the Black Lung and the Railroad Retirement programs were increased in 1981, and new limits were imposed on federal benefits under the Black Lung program. These changes were expected to maintain the solvency of these two funds over the long run, although continued declines in railroad employment could threaten the solvency of the Railroad Retirement System.

The unemployment trust fund faces more immediate problems of solvency. The UI system has been in financial trouble since the recession of 1973-1975. Since then, 30 states have borrowed from the federal government to pay benefits, and $10.6 billion was outstanding in loans at the end of calendar year 1982. The frequent and severe recessions of 1973-1975, 1980, and 1981-present have not allowed the system an opportunity to replenish reserves. The future financial picture for UI will depend largely on the extent of future unemployment.

TABLE V-2. REVENUE GAINS FROM REVENUE-INCREASING STRATEGIES IN OTHER ENTITLEMENT PROGRAMS (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increases
Provide Additional Revenues for Programs Financed Through Trust Funds						
Index Tax Base for UI System	0.9	1.8	2.8	3.9	5.4	14.8
Tax Certain Benefits for Individuals						
Tax All of UI Benefits	a/	1.7	1.6	1.7	1.6	6.6
Tax 40 Percent of Railroad Retirement Benefits	0.5	0.7	0.8	0.8	0.8	3.6
Tax Veterans' Compensation Benefits	1.1	1.8	1.8	1.8	1.8	8.4
Tax Workers' Compensation Benefits	1.5	2.4	2.8	3.2	3.6	13.5

a. Less than $50 million.

To reduce federal outlays for the UI program would be difficult, because more than half of these outlays are actually expenditures by state UI programs, and states control the level of benefits in both the state and federal UI programs. (Both state expenditures and employer tax payments appear in the federal budget because they flow through the federal unemployment trust fund.) An alternative would be to increase UI revenues, which could be done by expanding the UI tax base.

Index the Tax Base for the Unemployment Insurance System. The tax base for the federal unemployment payroll tax is currently $7,000 per worker, having been increased only three times from its level of $3,000 in 1940. During that time, the proportion of wages subject to the federal tax has fallen from over 90 percent of total wages to less than 50 percent. The federal tax base also serves as the minimum base for state UI taxes. While the UI tax base has increased infrequently, UI benefits have tended to rise as wages rise: benefits are based in part on prior earnings, and many states index changes in their maximum weekly benefit to changes in the average weekly wage in the state.

The federal UI tax base could be tied to increases in average earnings in the economy, as is done with the Social Security tax base. This would generate about $900 million in additional revenues in 1984, and about $15 billion over the 1984-1988 period. This option would cause revenues to increase as benefits grow, and could help to stabilize the long-term financial situation of the UI system. On the other hand, increases in the UI payroll tax would increase the cost of employing workers, and could decrease the number of jobs available, at a time when unemployment is already very high.

Tax Certain Benefits for Individuals

Another strategy for increasing federal revenues and improving the targeting of program aid would be to subject benefits received by individuals to the federal income tax. This strategy was discussed in Chapter III with regard to Social Security benefits, and it could be applied to other programs such as Unemployment Insurance, Railroad Retirement, Veterans' Compensation, and workers' compensation. 4/ Since income tax rates rise with income, making these benefits subject to the federal income tax would be equivalent to a graduated reduction in benefits, focusing on those with higher incomes. If revenues from these taxes were allocated to the respective trust funds, this type of option could also be used to bolster trust fund balances.

Taxing these benefits would also reduce the existing differences in the tax treatment of benefit income and income from other sources. This principle could also be applied to other benefit payments to individuals,

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4. Unemployment Insurance benefits received by those with incomes over $18,000 per couple and $12,000 per single person are currently subject to tax. One-half of each dollar of income over these limits, up to the full amount of the UI benefit, is included in the recipient's adjusted gross income for the purposes of the federal income tax.

almost all of which are currently tax-free. Revenue gains from taxing benefits from means-tested programs would be small, however, since few people who qualify for means-tested programs would have enough income to incur any tax liability. Some examples of revenue gains that could be obtained from taxing entitlement benefits are shown below.

Tax All of Unemployment Insurance Benefits. Unemployment Insurance benefits generally are included in taxable income for individuals with incomes--including UI benefits--above $12,000, and for couples with incomes above $18,000. Recipients whose incomes only slightly exceed those thresholds have only a portion of their benefits added to taxable income, however, with the amount increasing with income. The taxable-income thresholds were lowered in 1982--they had been $20,000 and $25,000, respectively, since 1979. Including all of UI benefits in taxable income starting in 1985 would increase revenues by about $6.6 billion in 1984-1988.

Taxing all of UI benefits would result in additional tax liabilities for some UI beneficiaries, but the tax law itself exempts from tax incomes below certain levels--$7,400 for a family of four, for example. Proponents of this change maintain that it would result in more equal tax treatment of persons with similar incomes from different sources. This change would provide an added incentive for affected persons to seek reemployment, by reducing the value of their UI benefits compared with their after-tax income from earnings. If the change induced workers to find jobs more quickly, it would also reduce UI outlays by shortening the duration of UI payments. Since marginal tax rates below $12,000 and $18,000 are not high, however, this additional incentive might not be great.

Opponents argue that taxing the UI benefits of moderate and low-income persons would result in reduced incomes for those who can least afford it. In addition, because of the difficulty of finding employment in a period of high joblessness, taxation of benefits might have little effect in getting people back to work, in spite of any increase in work incentives.

Tax 40 Percent of Railroad Retirement Benefits. Taxing the portion of Railroad Retirement benefits that does not substitute for Social Security benefits and allocating the income received to the Railroad Retirement trust fund would be another way to decrease the projected federal contribution to benefit funding, and would reduce the existing anomalies between the tax treatment of such benefits and of private pensions. The revenue gain from this option would be about $500 million in 1984 and about $3.6 billion in 1984-1988.

The Railroad Retirement System (RRS) is an industrywide pension plan, which currently pays benefits to nearly one million annuitants and receives payments from about 400,000 railroad workers. Railroad Retirement predates and remains independent of the Social Security program, although the two systems now have many common features and coordinate their coverage. Unlike any other private pension, RRS is managed by the federal government, and the retirement income it provides is almost entirely tax-free. [5]

Since 1975, RRS has been structured to parallel the two-part retirement income available to employees in the rest of the private sector: a Tier I component that both substitutes for Social Security coverage and provides certain extra benefits, and a Tier II component that resembles an employer pension and may be supplemented by longevity payments. Both are financed through the Railroad Retirement trust fund, which, like the Social Security trust funds, receives contributions from both employers and employees. [6] Because of the current recession, railroad employment has dropped precipitously, and the RRS faces financing problems in the near future.

If RRS benefits were treated in the same way as private-sector pensions, the portion that substitutes for Social Security would be tax-free, but both the "extra" benefits under Tier I and the Tier II employer pension component would be taxable to the extent that benefits exceeded employee contributions. Determining the appropriate tax under such a treatment would be administratively difficult, however. Approximately the same revenue increase could be achieved by taxing 40 percent of each RRS pension. If taxes are imposed on half of the Social Security benefits received by single persons with incomes over $20,000 and by couples with incomes over $25,000, as proposed by the National Commission on Social Security Reform, it might also be appropriate to tax more than 40 percent of the RRS benefits received by higher-income beneficiaries.

If benefits were made taxable, railroad annuitants would lose the substantial tax advantages they enjoy under current law. For example, a

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5. The only RRS benefits subject to federal income tax are supplemental longevity payments for retirees with the equivalent of 25 or more years of railroad service. These benefits began in 1966 and cannot exceed $840 a year. No taxes are collected, however, unless an RRS annuitant over age 65 has taxable income exceeding $4,300 if single and $7,400 if married and filing a joint return.

6. The Railroad Retirement trust fund also receives transfers from the Social Security funds to cover the costs of providing Social Security benefits for eligible railroad annuitants.

married annuitant under 65 with a pension of $21,000 a year--a typical level for a new retiree--now pays about $750 less in income taxes than retirees receiving the same income from a combination of Social Security and a private pension. 7/ Taxing Tier II benefits would reduce this tax advantage; nonetheless, RRS would still offer after-tax benefits comparing favorably with others in private industry. This option would have little or no effect on low-income annuitants because, even if RRS benefits were included in taxable income, such beneficiaries would still have incomes too low to make them liable for federal taxes.

Tax Veterans' Compensation Benefits. A third type of currently untaxed benefit is compensation for veterans with service-related disabilities, who are eligible for monthly cash benefits under the Veterans' Compensation program. Veterans' Compensation is the second largest non-means-tested program discussed in this chapter, and unlike UI it has not been significantly reduced in the recent past. Benefits are paid according to the degree of disability, and now range from $62 a month for 10 percent disability to $1,213 a month for complete disability, with payments of up to $1,350 a month in addition for veterans who require trained medical attendants, and up to a total of $2,111 a month for veterans who have suffered certain specific severe disabilities. Benefits are tax-free and paid without regard to income from other sources. If disability compensation was made taxable, the revenue gain would be $1.1 billion in 1984 and $8.4 billion in 1984-1988.

As with RRS benefits, taxing Veterans' Compensation benefits would have the advantage of targeting the reductions in after-tax income on those most able to afford them. Currently, Veterans' Compensation benefits are not reduced for veterans able to work or for those with other sources of income, and are thus not closely targeted to financial need. If benefits were made taxable, beneficiaries receiving additional income would pay higher taxes on their benefits than those relying on Veterans' Compensation alone. Like other proposals to tax benefits, this option would have the further advantage of treating incomes from different sources in the same way for tax purposes.

Any hardship resulting from taxation of benefits could be at least partially offset by increasing benefits 10 percent for beneficiaries who are 60 percent disabled or more--the group most likely to be in need because of earnings impairment. This group accounts for about 17 percent of the total number of beneficiaries, but receives about 60 percent of total benefits.

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7. When retirees and their spouses both reach age 65, this advantage declines to about $500, because of the extra $1,000 exemption available to all taxpayers over age 65.

Under this plan, however, the net budgetary gain would be reduced more than a fourth over the 1984-1988 period.

Those who oppose the taxation of Veterans' Compensation argue that disability compensation for those who suffered service-related injuries or illness should not be reduced because they have other sources of income, especially if the other sources are income from property or the labor of a spouse. In this view, veterans are owed their benefits in compensation for their service and the injuries they have suffered, without regard to their need.

Tax Workers' Compensation Benefits. A fourth type of benefit that is not currently taxed is workers' compensation. Most workers who suffer on-the-job injuries are insured by state-run, employer-financed workers' compensation programs. Workers' compensation payments cover medical expenses and some portion of income loss. If the payments for income loss were taxed beginning in 1984, federal revenues would increase by $13.5 billion over the 1984-1988 period.

The bulk of workers' compensation payments--about 70 percent--are made to compensate for income loss resulting from disability, rather than to cover medical costs. Assessment of a worker's degree of disability is necessarily inexact, and may or may not correspond to actual income loss. In addition, benefits vary considerably across states--the maximum compensation in cases of total disability ranges from $112 per week in Mississippi to $942 per week in Alaska, for example.

Taxing benefits provided to compensate for income loss would eliminate existing anomalies in treatment between beneficiaries and those who earn equal amounts in wages, but who must pay taxes. Further, in some cases benefits may exceed the lost wages net of tax, giving beneficiaries little incentive to return to work.

On the other hand, benefit levels differ significantly from state to state, and some hardships might result if low-benefit states did not increase their benefits to take account of the tax. In addition, because court-awarded damages for income loss due to non-workplace injuries are not subject to tax, it could be argued that it would be unfair to subject similar payments to tax in the case of workplace injuries.

STRATEGIES TO REDUCE OUTLAYS

This section examines several examples of the two strategies to reduce outlays in the other entitlements programs. These examples are summarized in Table V-3.

TABLE V-3. BUDGET SAVINGS FROM OUTLAY-REDUCING STRATEGIES IN OTHER ENTITLEMENT PROGRAMS (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Increase the Targeting of Aid on the Neediest						
Eliminate Veterans' Compensation Payments for Those with Low-Rated Disabilities						
Budget Authority	2.0	2.1	2.2	2.3	2.4	10.9
Outlays	1.8	2.1	2.2	2.3	2.3	10.7
Reduce the GSL Subsidy for Professional Students						
Budget Authority	a/	0.1	0.1	0.2	0.2	0.5
Outlays	a/	a/	0.1	0.2	0.2	0.5
Reduce Subsidy for Nonpoor Children in the Child Nutrition Programs						
Budget Authority	0.3	0.3	0.3	0.3	0.3	1.5
Outlays	0.3	0.3	0.3	0.3	0.3	1.5
Limit General Revenue Sharing to Fiscally Distressed Localities						
Budget Authority	1.4	1.5	1.6	1.7	1.7	7.9
Outlays	1.1	1.5	1.6	1.6	1.7	7.6
Reduce Inconsistencies Among Programs						
Reduce the Special Allowance to Lenders in the GSL Program						
Budget Authority	a/	a/	0.1	0.1	0.1	0.4
Outlays	a/	a/	0.1	0.1	0.1	0.3

a. Less than $50 million.

Increase the Targeting of Aid on the Neediest

In addition to taxing benefits, another way to target benefits more closely on those who are the neediest would be to narrow the focus of benefit awards in some programs. Although much has been done in this direction within the means-tested programs over the last two years, further steps could be taken to improve the targeting of aid in other programs like Guaranteed Student Loans, General Revenue Sharing, and Veterans' Compensation.

Eliminate Veterans' Compensation Payments for Those with Low-Rated Disabilities. An alternative method of improving the targeting of Veterans' Compensation benefits, other than subjecting them to the income tax, would be to eliminate cash payments to veterans with low-rated disabilities, while retaining their medical and health benefits. If cash benefits were eliminated for those with disability ratings of 30 percent or less, savings would be $1.8 billion in 1984 and $10.7 billion in 1984-1988.

Proponents of this cut argue that many veterans with low-rated disabilities do not suffer diminished work capabilities and, hence, should not be compensated. Elimination of these benefits would also result in more comparable treatment of disabled veterans and other recipients of disability benefits. On the other hand, many believe that compensation is owed to veterans for injuries and illness suffered while in service, without regard to their financial need.

Another way of targeting benefits for disabled veterans would be to eliminate dependents' allowances for those with disability ratings below 50 percent, which would save about $135 million in 1984. 8/ Like the previous approach, this might create additional work incentives for some disabled veterans who are in fact able to work. On the other hand, some veterans with disabilities in the 30 to 40 percent range may suffer substantial earnings impairment, and this option could create hardships for such veterans, especially if they have several dependents.

Reduce the GSL Subsidy for Professional Students. Obligations for the Guaranteed Student Loan program rose rapidly between 1978 and 1981--from $700 million to $2.8 billion--after the Congress made all borrowers,

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8. Before 1978, only veterans with disability ratings of 50 percent or more received such allowances, but under current law payments for dependents are received by veterans with disability ratings of 30 percent or higher, although payments are prorated according to the degree of impairment.

regardless of family income, eligible to have the interest on their loans paid by the government while they were in school. Under the 1981 Reconciliation Act, GSL borrowers remain eligible for the in-school interest subsidy, but loans are limited to families with incomes under $30,000 or with demonstrated financial need. The act also added a requirement that borrowers pay an origination fee equal to 5 percent of the amount borrowed. For all new GSL borrowers, the government currently pays 9 percent interest on their behalf while they are in school. It also pays the lender a variable amount, currently about 3 percent, during the life of the loan.

Even with the recently imposed income test, however, most graduate and professional students are likely to continue to qualify for GSLs. The GSL subsidy could be further targeted by eliminating the federal in-school interest subsidy for professional students, thereby reducing their long-term subsidy by about half. If students were allowed to borrow the interest while in school, this option would save about $500 million during the five-year period 1984-1988.

The argument for this change is that the entire current GSL subsidy may not be necessary for professional students, since they have better income prospects than other students, and most could be expected to pay the in-school interest in the form of higher repayments after graduation. On the other hand, under this option some lenders might drop out of the program because of its increased complexity, which would make GSLs harder for students to obtain.

Reduce the Subsidy for Nonpoor Children in the Child Nutrition Programs. The child nutrition programs, the largest of which is the National School Lunch program, provide cash and commodity assistance to schools and other institutions that serve meals to children. The programs reimburse these institutions for all qualifying meals served. The level of reimbursement in most of these programs depends on the income of the child's family.

In the National School Lunch program, for example, most schools receive $1.15 in cash reimbursement for each meal served to children from households with incomes below 130 percent of the poverty line, and lunches are served without charge to these children. For children from households with incomes between 130 percent and 185 percent of the poverty line, most schools receive a subsidy of 75 cents per lunch. Similarly, for children with household incomes above 185 percent of the poverty line, the subsidy is 11 cents per lunch. Comparable three-tiered reimbursement schedules are used in the School Breakfast program and in a portion of the Child Care Feeding program. Schools receive commodity assistance in addition to cash assistance for all meals served.

Eliminating the cash reimbursement for meals served to children from households with incomes over 185 percent of the poverty line--that is, with more than about $18,000 per year for a family of four in 1982, for example--would reduce federal expenditures by about $270 million in 1984, and about $1.5 billion over the 1984-1988 period. Savings would depend in part on the response of participating institutions to this change. Some schools, for example, might choose to drop out of the program if they judged that the federal reporting requirements and restrictions on meal composition were too burdensome to make continued participation worthwhile, or if too few children continued to participate in the program. The greater the number of schools that dropped out of the program, the greater would be the federal savings.

Proponents of this option argue that reimbursements for meals served to nonpoor children provide subsidies to households that are not in need of such assistance, and this change would therefore result in better targeting of nutrition assistance to those most in need. Opponents argue that meals qualifying for reimbursement under these federal programs are nutritionally superior to those from alternative sources, and eliminating subsidies for nonpoor students could result in lower quality meals. Further, a reduction in the subsidy might cause schools and other institutions to drop out of the program, thus denying poor children the benefits of free and reduced-price meals.

Limit General Revenue Sharing to Fiscally Distressed Localities. The General Revenue Sharing program provides unrestricted grants to general-purpose local governments--counties, cities, and townships. State governments were also entitled to funds until 1981, when they were eliminated on the ground that their fiscal condition no longer warranted federal subsidy. A similar approach could be applied to local government funding, eliminating the entitlement status of localities and providing funds only to jurisdictions with relatively low fiscal capacity or high tax efforts. If eligibility were limited in this way and funds were cut by 30 percent, federal savings would total about $1.1 billion in 1984 and $7.6 billion in 1984-1988.

Limiting funds to local governments most in need of federal aid would reduce the cost of GRS while maintaining support for governments experiencing the most fiscal stress. It would, however, further reduce aid to local governments at a time when cutbacks in other federal grant programs and the poor performance of the economy have left even relatively well-off jurisdictions in fiscal difficulty.

Reduce Inconsistencies Among Programs

Finally, a fourth strategy for reducing entitlement outlays would be to reduce inconsistencies among benefit programs. An example of such a strategy would be to reduce special allowances to lenders in the GSL program to levels more consistent with market rates of return for similar risk-free investments. The elimination of Trade Adjustment Assistance, which provides benefits to some, but not all, dislocated workers, would be a another example of this approach. It is not discussed here, however, because it would provide only small savings--less than $50 million in 1984, for example. If cost-of-living adjustments in the Social Security program are delayed six months as has been proposed by the National Commission on Social Security Reform, a similar delay in the cost-of-living adjustments for other indexed programs such as SSI, food stamps, and the veteran's programs could constitute a third example of this strategy. Such a delay would save about $800 million in 1984. 9/

Reduce the Special Allowance to Lenders in the GSL Program. This option would reduce yields for lenders providing student loans. Current yields may provide a larger return than necessary to induce lenders to participate--they receive 3.5 percentage points more than the bond-equivalency rate for 91-day Treasury bills, for example. On the other hand, substantial cuts in yields could drive lenders out of the program.

This potential problem could be avoided in two specific ways. Lenders' yields could be lowered in steps--with the lowest yield going to those with the largest volume, thus taking account of lenders' economies of scale. Alternatively, lenders' yields could be reduced while students are in school, since servicing costs are lowest during this period. Although savings would be small in the first few years under this option, each one-half percentage point reduction in the yield on new loans would reduce spending by about $300 million over the next five years.

CONCLUDING COMMENTS

Substantial reductions were enacted in most of the entitlement programs included in this chapter in 1980 and 1981, and further large savings would be difficult to achieve in many of them without major changes in program coverage and aims. This is especially true for the means-tested

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9. See Chapter III for further discussion. Savings estimate is preliminary and includes COLA delays in Veterans' Compensation, Railroad Retirement, SSI, Veterans' Pensions, and food stamps.

programs, as discussed above. Depending on the specific proposals, further reductions in other programs like Guaranteed Student Loans, General Revenue Sharing, and the child nutrition programs could also result in significant changes in their scope and purposes. This chapter does discuss some proposals for reducing outlays in these latter three programs, however, by improving the targeting of benefits and reducing lender allowances. Together, these strategies could save about $10 billion in 1984-1988.

Reductions in unemployment benefits in a period of high unemployment rates could also have substantial drawbacks, although the solvency of the Unemployment Insurance system is now under threat. High unemployment rates have reduced the reserves of the UI system, and 30 states have had to borrow from the federal government in order to pay benefits. Solvency could be restored by increasing the UI tax base, which has decreased in real terms as wages have grown. If the tax base were expanded each year in the same way as the Social Security tax base, $15 billion in additional revenues would be generated in 1984-1988.

This chapter also discusses some non-means-tested benefit programs that have not been reduced substantially in the recent past and that do not provide countercyclical benefits. These include Veterans' Compensation, the Railroad Retirement System, and some state-administered benefits like workers' compensation. Compensation for disabled veterans is relatively generous, especially for those with low levels of disability. If benefits for those with low levels of disability were eliminated, savings of over $10 billion would result over the 1984-1988 period.

Alternatively, revenues could be increased by subjecting benefits from Veterans' Compensation, Railroad Retirement, and state workers' compensation programs to the federal income tax. This would make their treatment more comparable to that of UI benefits, which are already taxed for recipients with incomes above certain limits. In addition, taxation of UI benefits could be extended to all recipients. Imposing the federal income tax on the first three types of benefits would generate revenue increases of more than $25 billion in 1984-1988. Including UI benefits in taxable income for all recipients would produce additional revenues of almost $7 billion over that period.

CHAPTER VI. AGRICULTURAL PRICE SUPPORT PROGRAMS

Outlays for agricultural price support programs rose sharply in 1982 to a record $11.6 billion, nearly three times more than outlays in 1981. This dramatic rise in spending reflected a sharp decline in farm prices resulting from large U.S. crops and weak export demand. For 1983, despite some program changes, outlays are projected to be $6 billion higher.

These expenditures are made through a number of agricultural commodity programs designed to support and stabilize farm prices and incomes. The programs use several tools, including commodity loans and purchases, direct payments, and supply controls. The principal commodities covered by these programs are wheat, corn and other feed grains, rice, upland cotton, tobacco, peanuts, milk, and wool. The focus of this chapter is on grains, upland cotton, and milk price support programs, which account for most price support outlays. The key elements of these programs are as follows:

- Grain and upland cotton prices are supported through nonrecourse loans. Farmers may put crops in storage and use them as collateral for government loans. The government agrees to accept a commodity as full satisfaction for repayment if the farmer elects not to repay in cash. A farmer may choose to repay the loan plus interest on or before its maturity date (usually nine months) and take over the storage and marketing.

- Wheat and feed grain farmers may also participate in the farmer-owned grain reserve. Under the reserve program, a farmer contracts to store grain for a three-year period in exchange for a government loan (at a loan rate higher than for nonrecourse loans) and annual storage payments. Grain in the reserve cannot be sold, except with a financial penalty, until the market price reaches the trigger release price at which time storage payments cease. If market prices are at or above the trigger release price, a farmer can repay the loan plus any interest or unearned storage payments. In the event that market prices never reach the trigger release price in the three-year period, a farmer would have essentially the same options as under nonrecourse loans.

- Grain and upland cotton farmers' incomes are supported through deficiency payments when national average market prices for a specified period fall below target prices. For example, the deficiency payment per bushel of wheat is the smaller of: (1) the difference between the national average market price for the first five months of the marketing year and the target price for wheat; or (2) the difference between the average market price and the nonrecourse loan for wheat. In 1982, the deficiency payment per bushel of wheat was $0.50, which was the difference between the nonrecourse loan rate of $3.55 per bushel and the target price of $4.05 per bushel--the average market price for the appropriate period being $3.34 per bushel.

- Grain and upland cotton farmers may be asked to reduce planted acreage from predetermined base levels to be eligible for the above program benefits. Further, they may be offered diversion payments for additional acreage reduction.

- Milk prices are supported through government purchases of surplus manufactured dairy products--cheese, butter, and nonfat dry milk.

Agricultural price support programs are entitlement programs that require the payment of benefits to any eligible individual. Most price support outlays are for price support loans and purchases, and direct payments to farmers. Federal spending for these programs is measured by net price support outlays, which are cash outlays minus cash receipts. Agricultural price support programs are financed through the Commodity Credit Corporation (CCC)--a government-owned corporation--which operates on borrowing authority from the Treasury as established by the Congress. The CCC receives an annual appropriation to reimburse it for unrecoverable losses incurred two years earlier.

BUDGET HISTORY AND PROJECTIONS

The Congress addressed the problem of rising price support outlays in the Omnibus Budget Reconciliation Act of 1982. This act authorized acreage-diversion payments for 1983 grain and cotton crops in order to increase prices and reduce outlays. It also provided for an assessment on milk sold by farmers intended to offset the costs of the dairy price support program. Because most of the budget effects of this retrenchment in federal support to crop farmers will not show up until 1984, however, outlays in 1983 are expected to continue increasing to $17.6 billion. Price support outlays for 1984-1986 are projected to average $7.0 billion.

Recent History, 1980-1982

Crop programs accounted for most of the increase in price support outlays in 1982 (see Table VI-1). The sharp run-up in crop outlays was caused mainly by record 1981 crops of wheat, feed grains, and upland cotton in the face of stagnant export markets resulting from poor economic conditions abroad and from the strength of the U.S. dollar. Crop prices fell by about 25 percent for corn and upland cotton, and 10 percent for wheat. As a result, farmers placed their crops under loan, particularly in the farmer-owned grain reserve, and received deficiency payments triggered by low prices. Of the $9 billion in crop outlays in fiscal year 1982, $7 billion was price support loans, $1.2 billion was deficiency payments, and $0.5 billion was reserve storage payments.

TABLE VI-1. FEDERAL OUTLAYS FOR AGRICULTURAL PRICE SUPPORT PROGRAMS (In billions of dollars)

	Actual		Estimated	Baseline Projection				
Major Program	1980	1982	1983	1984	1985	1986	1987	1988
Wheat	0.9	2.2	4.1	2.0	1.4	0.7	0.8	0.5
Feed Grains	1.3	6.4	6.1	3.1	2.6	1.5	1.3	1.1
Rice	-0.1	0.2	0.6	0.4	0.3	0.3	0.4	0.4
Upland Cotton	0.1	1.2	1.3	1.4	1.1	0.2	0.6	0.5
Tobacco	-0.1	0.1	0.1	0.1	a/	a/	a/	a/
Peanuts	a/	a/	a/	a/	a/	a/	a/	a/
Dairy	1.0	2.2	0.9	0.4	0.3	0.2	0.1	0.9
All Other	-0.4	0.3	4.5	1.6	1.7	1.6	1.5	1.5
Total	2.7	11.6	17.6	9.0	7.4	4.5	4.7	4.9

NOTE: Commodity program outlays shown in the above table are CBO baseline outlays. They are rounded to the nearest $100 million. A minus sign indicates a net receipt. This baseline does not reflect the implementation of the payments-in-kind program but does assume acreage control programs in effect during fiscal years 1984-1988 and assessments on milk marketings in fiscal years 1983-1987.

a. Indicates outlays less than $50 million.

Further increases in outlays are estimated for fiscal year 1983 because of a continued growth in supplies relative to demand. Large crop inventories were carried into the 1982 crop year. Then, despite acreage reduction programs, feed grain production reached a record high and wheat production fell only slightly from 1981. These large supplies combined with declining exports are causing crop prices to continue low. At the end of the 1982 crop year, grain stocks will be about one-half of total annual use, far in excess of adequate stock levels. Few of these stocks will be held free of government control--about two-thirds of them will be in the farmer-owned reserve and about one-fifth will be government-owned. Upland cotton stocks at the end of crop year 1982 will also be excessive: about 70 percent of annual use, despite a 23 percent drop in cotton production.

The run-up of price support outlays in 1982 and 1983 followed a long period, 1968-1981, in which highly volatile outlays averaged $3.2 billion a year. Government policy since the mid-1960s has been to reduce real (adjusted for inflation) levels of price support and make crop farmers more dependent on markets. This transition to less restrictive government policy, together with rapidly expanding agricultural exports (which grew at a rate of 19 percent per year from 1970 through 1980), resulted for a time in declining real price support outlays even though annual crop production rose. (Output in 1976-1980 averaged about 25 percent larger than in 1967-1972.) As demonstrated in 1982, however, price support outlays can increase substantially if large crops coincide with weak export markets.

In contrast to crop policy, dairy price support policy has changed little. High milk price supports in the late 1970s encouraged excessive milk production and caused dairy price support outlays to increase. These outlays, which averaged just 5 percent of total price support outlays in 1968-1979, rose to nearly half of total outlays in 1980 and 1981. From $1.0 billion in 1980, they rose to $1.9 billion in 1981 and $2.2 billion in 1982. In 1983, however, net outlays for the dairy price support program are estimated to fall to about $0.9 billion because of farmers' payments to the government to help defray part of the costs of the dairy price support program. The Department of Agriculture, however, has been temporarily restrained by the U.S. District Court for South Carolina from collecting the assessment.

The Current Situation

In 1982, the Congress sought to reduce price support outlays. Two principal actions were taken in the Reconciliation Act of 1982, and a third in the No Net Cost Tobacco Program Act of 1982:

- The Reconciliation Act mandated paid acreage diversion for the 1983 crops of wheat, feed grains, and rice as a means to reduce outlays and improve farm prices. The Secretary of Agriculture, under previously existing authority, also implemented a paid acreage diversion program for upland cotton.
- The Reconciliation Act authorized the Secretary of Agriculture to impose an assessment on dairy farmers of $0.50 to $1.00 per hundredweight of milk sold to offset a portion of the cost of the dairy price support program.
- The No Net Cost Tobacco Program Act of 1982 requires tobacco farmers to contribute to a fund as a condition for eligibility for price support. The fund will ensure that the government does not suffer any loss from the tobacco price support program.

To be eligible for benefits under the 1983 grain and upland cotton programs, farmers must reduce acreage from 1982 base levels. For wheat, rice, and feed grains the total acreage reduction is 20 percent (for wheat and rice that total reduction includes 5 percent paid diversion, and for grains, 10 percent). Cotton farmers must reduce acreage by 20 percent and may divert an additional 5 percent for payment.

An assessment on dairy farmers of $0.50 per hundredweight of milk was implemented on December 1, 1982. The Secretary has the authority to assess an additional $0.50 per hundredweight on April 1, 1983, if estimated annual government purchases are at least 7.5 billion pounds milk equivalent. Purchases are expected to exceed that level in the current marketing year. This second phase also provides for refunds to dairy farmers who reduce milk production. The Reconciliation Act of 1982 also fixed the minimum price support level for 1983 and 1984 at $13.10 per hundredweight, the same as in 1982--thus eliminating the mandatory increases required by the Food and Agriculture Act of 1981.

The No Net Cost Tobacco Program Act makes tobacco farmers bear any net losses, either of principal or interest, incurred by the government in supporting tobacco prices through nonrecourse loans. Net losses under the tobacco price support program account for less than 1 percent of total government losses for all price support programs during the past five decades.

In addition to these actions by the Congress, in January 1983 the Administration announced a payments-in-kind program for 1983 wheat, feed grains, rice, and upland cotton crops. This program provides for payments in commodities to farmers who divert 10 to 30 percent of their base acreages in addition to the acreage reduction programs already announced. Payments for this additional acreage will be 95 percent of farm program yields for wheat, and 85 percent of such yields for feed grains, cotton, and rice. As an alternative to diverting 10 to 30 percent of base acreages, farmers may bid to withdraw their entire base acreage from production.

Baseline Projections, 1984-1988

Agricultural price support outlays under current policies are projected to average $6.1 billion over fiscal years 1984-1988. For the five-year period, outlays for major crop programs average $3.9 billion annually with deficiency payments accounting for a large proportion of these outlays. Dairy price support outlays--under the assumption that assessment revenues are collected through fiscal year 1987--average $280 million each year over 1984-1987.

DEFICIT REDUCTION STRATEGIES

Record price support outlays are primarily the result of large U.S. crops in 1981 and 1982 and a weak world economy. Stagnant export markets have been caused by several factors: little or no economic growth in many countries, financial instability in a number of countries, a strong U.S. dollar, continued East-West political tensions, and highly subsidized agricultural exports by other countries, mainly the European Community. Further, there is a growing protectionist sentiment worldwide as nations look for ways to protect their recession-plagued industries from imports. The strength of the U.S. dollar has resulted from the flow of foreign investment into the United States attracted by high interest rates. Therefore, even though the prices received by U.S. crop farmers have fallen over the past two years, importers in many foreign countries have not benefited proportionately because of the appreciation of the dollar, which in some cases has increased prices to importers.

Clearly, these international factors have a negative impact on U.S. crop farmers. For many of them, 1983 is expected to be the fourth consecutive poor income year as production expenses continue to rise but cash receipts remain stagnant. Furthermore, this bleak outlook, despite record price support outlays, demonstrates the problems in using such programs to offset the adverse consequences of large crops and of international events.

In an environment dominated by international economic conditions, the options for reducing crop price support outlays are limited. Since the immediate budget problem is one of excessive supplies, the general policy options are to reduce domestic supplies either by restricting production or by expanding exports. The effectiveness of export expansion policies is limited by the sheer size and complexity of international markets and by competition. Thus, restricting production is a more plausible option for bringing supplies in line with demand in order to reduce price support outlays.

Dairy farmers, unlike crop farmers, produce mainly for the domestic market. Although economic recession has dampened the demand for milk and dairy products, high price supports have continued to cause dairy surpluses with their attendant budget problems. Dairy farmers have increased milk production, by expanding herds and improving productivity per cow, to the point where annual milk production exceeds commercial use by 10 percent. This has not led, however, to any mechanism to control milk production such as exists for grains and cotton.

BROAD REDUCTION STRATEGIES

In this section two broad strategies for reducing price support outlays are examined: (1) reducing the level of federal support for crops and milk; and (2) restricting domestic crop production. The 1984-1988 savings from these strategies are displayed in Table VI-2.

Reducing the Level of Federal Support

Three possible ways of reducing federal support are: eliminating deficiency payments, capping the level of the farmer-owned reserve, and reducing the dairy price support level. Each of these three options, however, would reduce federal outlays at the expense of farmers' incomes.

Eliminate Deficiency Payments. In the mid-1960s, U.S. policy began to shift away from high domestic price supports and rigid supply controls, allowing domestic grain and upland cotton prices to adjust gradually to world price levels. From the mid-1960s to the early 1970s, farmers were assisted in making this adjustment through special payments averaging $3 billion annually. In 1973, these were replaced by deficiency payments for wheat, feed grains, upland cotton, and rice.

Altogether, in crop years 1974 through 1980, about $2.5 billion of deficiency payments were made. About $1.2 billion of deficiency payments were made for 1981 crops in fiscal year 1982 because of higher target prices and low crop prices, and because most farmers participated in the programs.

TABLE VI-2. BUDGET SAVINGS FROM BROAD REDUCTION STRATEGIES IN AGRICULTURAL PRICE SUPPORT PROGRAMS (In billions of dollars)

Strategy	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Reducing the Level of Federal Support						
Eliminate Deficiency Payments						
Budget Authority	--	--	1,935	3,540	3,580	9,055
Outlays	1,935	3,540	3,580	3,380	3,065	15,500
Cap the Farmer-Owned Reserve						
Budget Authority	--	--	110	--	--	110
Outlays	110	--	--	--	--	110
Reduce the Level of Dairy Price Support a/						
Budget Authority	--	--	-985	-290	60	-1,215
Outlays	-985	-290	60	200	1,135	120
Restricting Crop Production						
Budget Authority	--	--	450	5,490	1,660	7,600
Outlays	450	5,490	1,660	1,485	985	10,070

a. Minus sign indicates an increase as compared with the baseline.

Deficiency payments will reach about $1.5 billion for 1982 crops. These payments are highly concentrated among larger farmers and are of small economic consequence to most others. In crop year 1981, about 6 percent of participating producers received about 57 percent of total deficiency payments under the wheat, feed grain, and upland cotton programs--an average payment of $10,024 to each of these producers as compared with $551 for all other participants.

One can argue that deficiency payments have largely fulfilled their function. Eliminating these payments starting with 1984 crops would save $5.5 billion in fiscal years 1984 and 1985. Crop farmers' incomes would still be cushioned by other provisions of existing commodity programs--the farmer-owned grain reserve, crop loans, and acreage diversion payments. On the other hand, deficiency payments are estimated at nearly 10 percent of crop farmers' gross cash incomes in the 1983 crop year. Thus, in years of especially large commodity surplus, such as 1981-1983, the grain reserve, crop loans, and diversion payments may not provide farmers with adequate income support.

Cap the Farmer-Owned Reserve. The reserve was established to help farmers extend their marketing period in times of surplus production. It was also seen as a way to protect consumers from shortages and precipitously rising prices. The reserve has helped to even out supplies over time and to dampen grain price fluctuations. It has been used more and more as a supply control tool, and thus is now larger than necessary to protect against production shortfalls. At the end of the 1982 crop year, the reserve will contain about 3.5 billion bushels of wheat and feed grains--roughly equal to one year's exports. In fiscal year 1983, it will require outlays of $0.6 billion for storage payments. In addition to its budgetary costs, the reserve causes prices to rise in a period of large surpluses, stimulating production and exacerbating the supply/demand imbalance.

Capping the reserve at current levels would mean that about 600 million bushels of 1982 and 1983 crop grains would not be entered into the reserve. Overall savings from smaller loans and storage payments would be $1.8 billion in 1983 and 1984. Net budget savings would be much less, however, since farmers, no longer having access to the farmer-owned reserve, would most likely place the same amount of grain under nonrecourse loans. When those loans matured farmers would probably forfeit their grain to the government since market prices are expected to be lower than the loan rates plus interest. Under these conditions, the government would acquire grain and would have to pay storage and handling costs, which would reduce the budget savings from smaller reserve loans and storage payments. The net budget savings from capping the reserve would thus be about $210 million in 1983 and 1984. Most of these savings would occur because the nonrecourse loan rate is lower than the reserve loan rate. For farmers, this would mean a lower price for part of their grain.

Reduce the Level of Dairy Price Support. The dairy price support program has increased farm milk prices at the expense of consumers and taxpayers, but it has also helped to stabilize the dairy industry and provide an assured supply of milk and dairy products. In the past three years, however, milk price supports have been at a level that has contributed to a sharp expansion of milk production. Milk production in 1982 was nearly 10 percent greater than in 1979. The increase in milk production far exceeded the growth in consumption. As a result, in 1981 and 1982, the commercial supply of milk exceeded commercial use by about 10 percent, with all the excess purchased by the federal government at an annual average cost of almost $2 billion.

The 1982 Reconciliation Act authorized a slight reduction of dairy support prices for 1983 and 1984 and gave the Secretary of Agriculture the authority to impose assessments on milk marketings. These actions were intended to induce dairy farmers to decrease milk production and to help defray the government's cost of purchasing surplus dairy products.

The federal assessment on dairy farmers represents a per unit tax on each hundredweight of milk sold, thus transferring income from dairy farmers to the government. Since neither the support price nor the pricing system is directly affected by this tax, consumer prices will remain unchanged for at least the short term. Even though the net price received by dairy farmers is reduced by the amount of the tax, this is not expected to reduce milk production significantly. Large grain crops currently ensure relatively low feed costs, and cattle prices are not high enough to encourage the culling of dairy cow herds. Consequently, milk supply and demand are not projected to balance until after 1987. This means that government surplus purchases will continue at high levels and burdensome stocks will expand, even though assessment revenues will reduce price support outlays.

One optional approach to balancing supply and demand would be to eliminate the assessment on dairy farmers and, instead, reduce support prices so that consumers would benefit. In order to reduce support outlays sufficiently to offset the loss of potential assessment revenues in fiscal year 1983, the support price would need to be lowered sharply from the current level. This would have no net budget impact but would represent a large income loss to dairy producers and might destabilize the dairy economy, causing increased consumer costs later on. Alternatively, by decreasing the support price in five increments of $0.50 per hundredweight every six months beginning April 1, 1983, a gradual and more even reduction in milk production and increases in consumption could be achieved that would lead to smaller government purchases. Nevertheless, price support outlays would be larger than under the assessment scheme, by about $985 million in 1984 and $290 million in 1985.

Restricting Crop Production

Under current law the Secretary of Agriculture can restrict crop production by withholding program benefits from farmers who do not reduce planted acreage, and in addition by paying farmers for diverting acreage. Both of these tools are being used for 1983 crops: farmers must reduce planted acreage by a specified percentage from 1982 base levels, and for a portion of this reduced acreage they will receive diversion payments intended to compensate them for forgone income. These programs were implemented with the expectation that they would reduce production, boost prices, and decrease price support outlays.

Such voluntary acreage reduction programs, while consistent with the long-term policy objective of giving farmers greater freedom in managing their businesses, have a limited capacity to reduce production. There are two reasons for this. First, many farmers typically choose not to participate and may even increase acreage in the expectation that prices will be higher. Second, farmers who do participate tend to remove their least productive cropland, and may even take steps to increase yields on cropland they plant. The usual result is that the net reduction in total planted acreage is less than the acreage removed under the program, and average yields are higher, so that production does not decline in proportion to the acreage removed. Consequently, under current excess supply conditions, these programs cannot be expected to bring supplies into line with demand over the short term.

An alternative approach to restricting production would be mandatory acreage reduction. This policy--which would require legislation--would give the Secretary the authority to limit 1984 planted acreage to some proportion of each farmer's base acreage. Farmers would still be eligible for nonrecourse loans, the farmer-owned grain reserve, and deficiency payments. Enforcement procedures and penalties would have to be established.

As compared with the present policy, programs mandating acreage reduction of 25 percent for the 1984 wheat and corn crops would:

- Increase season average wheat and corn prices by 10 to 15 percent;

- Reduce 1984 ending corn and wheat stocks by 25 and 10 percent, respectively; and
- Reduce 1984 and 1985 outlays by $5.9 billion (see Table VI-2). The savings would come from loan repayments, principally farmer-owned reserve loans, smaller reserve storage payments, and reduced deficiency payments.

Since stocks would be drawn down to meet demand in excess of production, 1984 ending stocks would be closer to adequate levels. This would improve crop farmers' prospects for 1985.

Higher grain prices would have very small impacts on retail food prices and on overall consumer prices. Manufacturers might experience a decline in sales to farmers in 1984, but this would probably be reversed as higher farm prices and incomes, along with improved prospects for 1985, contributed to increased demand for production inputs. In foreign trade, higher U.S. crop prices could cause a slight reduction in export demand, especially if the dollar remained strong relative to other currencies. To the extent that this led to increased production in other exporting nations, it could intensify competition in world markets and possibly dampen the increase in U.S. crop prices.

Mandatory acreage reduction would mean at least a temporary increase in government intervention in farming. This policy, however, would perhaps be more equitable in that all crop farmers would share in the adjustment. Unlike under voluntary programs, it would eliminate the prospect that participants might lose and nonparticipants gain. In the past, crop farmers generally were given the opportunity to vote via referendums whether they favored acreage allotments and marketing quotas. Mandatory acreage reductions for 1984 could be put to the same test.

TARGETED REDUCTION STRATEGIES

Three targeted reduction strategies are discussed in this section, and their savings are displayed in Table VI-3. These savings are relatively small, however, compared with those discussed above.

Eliminate the Wool and Mohair Program. The National Wool Act of 1954 authorized payments to farmers on marketings of shorn wool, unshorn lambs, and mohair. Payments are at a rate approximating the difference between the support price established in the law and the national average price received by farmers. The program was enacted as a measure of national security and general economic welfare, because shorn wool was

TABLE VI-3. BUDGET SAVINGS FROM TARGETED REDUCTION STRATEGIES IN AGRICULTURAL PRICE SUPPORT PROGRAMS (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Eliminate the Wool and Mohair Program						
Budget Authority	--	65	76	85	92	318
Outlays	65	76	85	92	96	414
Eliminate the Honey Price Support Program						
Budget Authority	--	--	33	36	38	107
Outlays	33	36	38	40	41	188
Place the Peanut Program on a No-Net-Cost Basis						
Budget Authority	--	--	38	38	38	114
Outlays	38	38	38	38	38	190

considered an essential and strategic commodity. The objective was to encourage annual domestic production of 300 million pounds of shorn wool.

About $1.3 billion has been paid to farmers since the inception of the program; the amount in 1982 was $42 million. Even so, domestic wool production has declined by more than one-half since 1954 and is now about 100 million pounds a year. The program has been in direct conflict with the reality of declining lamb and mutton consumption and rising use of synthetic fibers. Eliminating this program would save about $414 million over the 1984-1988 period.

The elimination of program payments would reduce farmers' cash receipts from the marketing of wool and mohair by about a third. Federal payments, however, are only about 10 percent of the total cash receipts that farmers receive from the sale of sheep, lambs, and wool. These payments are made to just 80,000 farmers and average only $400 per farmer.

Consequently, the elimination of payments would be of small economic consequence to most farmers.

Eliminate the Honey Price Support Program. Honey producers' incomes are supported through government loan and purchase activities operated by the CCC. For the past several years, the price support loan has been set at 60 percent of the honey parity price--the minimum required by law. Prior to the 1980 honey marketing year, market prices remained above the loan rate, and while there was loan activity the government acquired no honey. In 1980 the parity index increased sufficiently to raise the loan rate to almost the market price, and in 1981 the loan rate increased further so that it exceeded the market price. As a result, in 1981 the government acquired 37 million pounds of honey at a cost of about $27 million.

The price support program results in higher prices not only for domestic producers but for foreign producers as well. About 200 million pounds of honey are produced annually in this country--about 75 percent of domestic consumption. Imports make up the difference. Imports have increased nearly 30 million pounds in the past two years in response to higher support price levels. Honey imports, most of which are from Mexico, China, Canada, and Argentina, are not subject to import quotas and bear only a small duty.

Eliminating the honey program would benefit consumers by allowing prices to fall below support levels. Domestic producers would suffer some loss of income from lower prices, and imports would likely fall. The government would save the expense of acquiring honey, estimated to be $190 million in 1984-1988.

Place the Peanut Program on a No-Net-Cost Basis. The peanut program supports producers' prices and incomes through nonrecourse loans and poundage quotas which restrict the quantity of peanuts eligible for preferential loan rates. Peanuts produced in excess of the poundage quota are supported at a substantially lower loan rate. The peanut program is similar in many respects to the tobacco program. Peanut producers, like tobacco producers, could be assessed in order to assure that the government does not incur any realized losses.

Estimated savings from fees would be $190 million in 1984-1988. The fees would recover the costs of storage, transportation, and losses on nonrecourse loans.

CONCLUDING COMMENTS

Two broad strategies have been outlined for reducing crop price support programs. Restricting production through mandatory acreage controls would increase government intervention in agriculture, in contrast to recent policy trends. On the other hand, eliminating deficiency payments would be consistent with the policy transition.

Changing world economic conditions could affect the relative merits of these two budget reduction strategies. A fairly rapid improvement in the world economy would stimulate U.S. farm exports--thus reducing excess supplies, raising farm prices, and reducing federal outlays. This would lessen the adverse consequences of eliminating deficiency payments, and intensify the negative price and income effects of restricting production. Alternatively, a slow rate of growth in export demand would mean continued low prices and big outlays. It would exacerbate the adverse effect of eliminating deficiency payments, but would minimize the negative effects of restricting production.

In the short term, there appears to be little prospect of any significant increase in export demand. From this viewpoint, mandatory acreage controls for 1984 offer a means to reduce supplies, increase farm prices, and reduce outlays. This policy would save about $5.5 billion in 1984 and 1985, similar to the savings from eliminating deficiency payments. Unlike the elimination of deficiency payments, however, mandatory acreage controls would not reduce crop farmer's gross cash incomes.

An argument can be made for longer-term acreage adjustment policies that would retire land from production for several years. The outsize crops of recent years suggest that the present program for managing supply may be inadequate, particularly in light of the poor outlook for exports. Restricting land under cultivation until demand can grow into balance with world supplies might be less costly to the federal budget than are the present annual attempts to control production on all of U.S. cropland.

The dairy price support program poses another policy dilemma. Currently, dairy farmers are taxed to help defray part of the costs of the price support program. These revenues reduce price support outlays, but do not result in lower prices and increased consumption. Government surpluses are expected to grow even though part of their acquisition and disposal costs are paid by farmers. The policy dilemma is that a practicable alternative approach such as gradually reducing the level of price support would benefit consumers but would most likely cause outlays to increase over the next two years.

CHAPTER VII. NONDEFENSE DISCRETIONARY SPENDING

More than one-half of all federal budget accounts are in the category "nondefense discretionary spending." Despite its vast range--it encompasses all or part of 16 of the 19 budget functions--spending in this category totaled only $137 billion in 1982, or less than one-fifth of all net federal budget outlays. This was a sharp drop from the 1980 level, when nondefense discretionary programs accounted for nearly one-fourth of all outlays. Off-budget outlays for these programs added $17 billion to 1982 expenditures.

Nondefense discretionary spending ranges from international affairs to energy, education and training, and transportation. It also includes all of the expenses of operating the federal government, except for defense-related agencies. The programs included in this category are classified as "discretionary" because--unlike the entitlement programs described in Chapters III-VI--spending in these areas is fixed directly by the Congress, generally through the annual appropriations process.

In this chapter, nondefense discretionary programs are grouped into the following subcategories:

- **Grants to State and Local Governments.** This subcategory includes most aid that flows from the federal government to states and localities to be used for purposes specified by the federal government. Transportation, education and training, community and regional development, and natural resources and environmental assistance make up the bulk of programs in this subcategory. 1/

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1. As noted in earlier chapters, the Office of Management and Budget also classifies as grants to state and local governments several large entitlement programs that provide benefits to individuals, because the funds are distributed first to other governments before being passed through to the eventual beneficiaries. Such benefit-payment grants--among them, Aid to Families with Dependent Children, Medicaid, and child nutrition programs--are dealt with in Chapters IV and V and are therefore not included in the grants totals in this chapter. The General Revenue Sharing and Title XX Social Services block grant programs are also considered entitlements for the purpose of this

- **Assistance to Business and Commerce.** This includes subsidies for specific industries--such as low-interest loans to farmers, operating subsidies for shipowners, and low-interest loans to subsidize exports--as well as general aid to commerce.

- **Benefits and Services for Individuals.** This includes programs that provide direct federal financing for such benefits as veterans' health care and lower-income housing assistance.

- **Infrastructure, Environment, and Related Services.** This includes direct federal spending for such services as environmental regulation, the national parks system, the work of the Bureau of Land Management and the Army Corps of Engineers, and the air traffic control system, which are available directly or indirectly to all citizens.

- **Research and Development.** This includes all research and development expenditures for purposes other than national defense.

- **Aid to Foreign Governments and International Organizations.** This includes all bilateral and multilateral economic and military assistance to foreign governments as well as U.S. payments to international organizations, such as the United Nations.

- **Other Government Operations.** This includes the costs of operating all three branches of the federal government, except for the Department of Defense and for those agencies and bureaus that provide federally administered services or conduct research and development.

BUDGET HISTORY AND PROJECTIONS

Spending for nondefense discretionary programs declined slightly between fiscal years 1980 and 1982, and is expected to increase in 1983 to just

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report and are covered in Chapter V. Finally, several state and local grants that are discretionary appropriated programs but that provide fully earmarked benefit payments for individuals--such as lower-income housing assistance--are counted in this chapter as direct federal benefits for individuals. For all these reasons, the state and local grants totals reported in this chapter will not agree with figures reported in other sources.

above the 1980 level--representing a substantial reduction over those three years, after adjusting for inflation. CBO's baseline projection assumes that beginning in 1984 spending in these programs will grow at about the same rate as inflation.

Recent History, 1980-1982

The first session of the 97th Congress, acting on proposals from the Reagan Administration, reduced funding for numerous nondefense discretionary programs and completely eliminated others. As a result, on-budget nondefense discretionary spending increased only slightly between 1980 and 1981, and declined in 1982 to below the 1980 level (see Table VII-1). Most of the spending growth that did occur over these two years was in benefits and services to individuals, research and development, and other government operations, although spending increased slightly for foreign aid as well. Spending for the other three nondefense discretionary subcategories combined fell by about $10 billion between 1980 and 1982, with the sharpest reduction occurring in state and local grants. Because of these cuts, total nondefense discretionary spending decreased by 18 percent in real terms between 1980 and 1982, and declined from 24 percent of net on-budget federal expenditures to 19 percent.

The Current Situation

After two years of little or no spending growth, outlays for nondefense discretionary programs are expected to increase somewhat between 1982 and 1983, but they will remain well below the 1980 level after adjusting for inflation. On-budget expenditures for the nondefense discretionary spending category as a whole are expected to rise to $145 billion in 1983, reflecting increases in all subcategories except state and local grants and assistance to business and commerce, which are expected to continue to decline. Between 1980 and 1983, total on-budget nondefense discretionary spending will grow by only $4 billion, leaving expenditures 16 percent below the 1980 level in real terms and shrinking total nondefense discretionary spending to 18 percent of the federal budget.

Baseline Projections, 1984-1988

CBO's baseline projections assume that funding for nondefense discretionary spending programs will increase from the 1983 levels at a rate sufficient to keep up with projected increases in the costs of the goods and services financed. On this basis, total on-budget expenditures for these

TABLE VII-1. FEDERAL OUTLAYS FOR NONDEFENSE DISCRETIONARY SPENDING
(In billions of dollars)

	Actual		Estimated	Baseline Projection				
Subcategory	1980	1982	1983	1984	1985	1986	1987	1988
Unified Budget Outlays								
State and Local Grants a/	52	45	44	47	50	52	54	56
Assistance to Business and Commerce	9	7	7	8	9	9	9	9
Benefits and Services for Individuals	23	25	28	28	30	32	34	35
Infrastructure, Environment, and Related Services	19	18	20	21	22	22	22	23
Research and Development	15	16	17	18	18	18	19	20
Aid to Foreign Governments and International Organizations	8	8	9	10	10	11	11	11
Other Government Operations	15	17	19	20	20	20	21	21
Civilian Agency Pay Raises b/	N/A	N/A	1	2	3	5	7	9
Subtotal	141	137	145	153	162	169	177	184
Off-Budget Outlays	14	17	17	15	16	19	17	17
Total, Unified and Off-Budget Outlays	155	154	162	168	178	188	194	201

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a. Includes only nonentitlement grants. Entitlement grants are described in Chapters IV-V.

b. Reflects outlay increases associated with projected comparability pay raises for civilian-agency employees.

programs would grow to $153 billion in 1984 and to $184 billion by 1988. This inflation-adjusted baseline is used to measure the impact of the further spending reductions identified in this chapter.

DEFICIT REDUCTION STRATEGIES

For the 1984 budget resolution, the Congress could approach nondefense discretionary spending in either of two ways, or through some combination of them. On one hand, the Congress could derive funding totals for this category by applying broad guidelines to all or most of this group of programs as a whole. Alternatively, funding totals could be developed by making spending assumptions about the individual programs and aggregating the effects of those assumptions. The organization of the rest of this chapter reflects these two approaches, first discussing general spending guidelines, and then examining examples of program-specific cutbacks.

GENERAL BUDGET GUIDELINES

This section describes three possible general budget guidelines for the nondefense discretionary spending category. These guidelines are summarized in Table VII-2.

Increase Funding by Less Than the Inflation Rate

One means of achieving savings in nondefense discretionary programs relative to the CBO baseline would be to allow funding to increase, but at some rate less than the anticipated rate of inflation. For example, the Congress could permit funding for appropriated accounts to rise by 2 percent per year from 1983 levels--about half the expected rate of inflation over the next five years--while permitting anticipated federal pay comparability increases to go forward. 2/ Such a guideline would permit outlays for nondefense discretionary spending to increase by more than $30 billion by 1988, but would achieve savings of nearly $1 billion in 1984 and more than $8 billion in 1988 relative to the CBO baseline, which is fully adjusted for inflation. Under this guideline, nondefense discretionary programs would decline in real terms by 2 percent between 1983 and 1988, and by 18 percent over the 1980-1988 period.

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2. Options for reducing federal employee compensation costs are discussed in Chapter VIII.

TABLE VII-2. SAVINGS FROM GENERAL BUDGET GUIDELINES FOR NONDEFENSE DISCRETIONARY SPENDING
(In billions of dollars)

Budget Guideline	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Increase Funding by 2 Percent per Year						
Budget Authority	2.2	4.5	6.9	9.5	11.8	34.9
Outlays	0.8	2.4	4.2	6.2	8.3	21.9
Freeze Funding at 1983 Levels						
Budget Authority	5.0	10.2	15.5	21.0	26.4	78.1
Outlays	2.1	6.0	10.6	15.6	20.7	55.0
Decrease Funding by 2 Percent per Year						
Budget Authority	7.8	15.9	24.1	32.5	41.0	121.3
Outlays	3.4	9.6	17.0	25.0	33.1	88.1

Freeze Funding at 1983 Levels

One obvious general budget approach would be to hold appropriations for the nondefense discretionary category at the 1983 level--permitting funding increases only to pay for federal pay adjustments. Under this guideline, outlays--or actual expenditures--would still rise by $18 billion between 1983 and 1988, with about half of that increase resulting from projected pay adjustments, and the other half resulting from expenditure growth that is already built into law, such as spending associated with the recently enacted increase in the motor fuels tax. Under this approach, annual savings relative to the CBO baseline would amount to about $2 billion in 1984, and almost $21 billion by 1988. This strategy would result in a 9 percent reduction in nondefense discretionary spending in real terms between 1983 and 1988, and a 24 percent real-dollar reduction over the entire 1980-1988 period.

Reduce Funding Below the Base-Year Level

If further savings were desired in nondefense discretionary spending programs--at the cost of still greater erosion in the level of services provided--funding for 1984 and thereafter could be reduced below the base-year level. As one example, 1984 funding for this category could be fixed at 2 percent below the 1983 level--except for anticipated federal pay increases--with funding for subsequent years reduced by an additional 2 percent annually. Such a strategy would achieve outlay savings of $3.4 billion relative to the inflation-adjusted baseline in 1984, rising to more than $33 billion by 1988. Adopting this guideline would result in a 30 percent real-dollar decline in spending for nondefense discretionary programs as a whole over the 1980-1988 period.

TARGETED REDUCTION STRATEGIES

Whatever general guidelines are employed in developing nondefense discretionary funding totals for the 1984 budget resolution, numerous program-specific decisions will have to be made, usually as part of the appropriations process. Indeed, the budget resolution itself could be constructed in such a "bottom up" manner--aggregating assumptions regarding eventual appropriations actions for individual programs.

The remainder of this chapter presents targeted budget reduction strategies and examples of specific spending cuts that might be applied to each of the seven program clusters identified at the outset of the chapter. [3]

State and Local Grants

The federal government provides grants to states and localities that help finance a wide array of public services. Several large entitlement grants, including the principal health care and income support programs for the poor, are discussed in Chapter V. Nonentitlement grants--examined below and summarized in Table VII-3--include state highway construction and repair grants, mass transit assistance, community and economic development aid, elementary and secondary education grants, employment and training aid, and pollution abatement assistance. In some instances, grants are earmarked to fund increased services for certain disadvantaged groups

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3. Examples of deficit reductions that could be achieved by establishing or increasing user fees for public services are discussed in Chapter IX.

TABLE VII-3. FEDERAL OUTLAYS FOR NONENTITLEMENT STATE AND LOCAL GRANTS (In billions of dollars)

Program	Actuals			Estimated
	1980	1981	1982	1983
Federal-Aid Highways	9	9	8	8
Elementary, Secondary, and Vocational Education	6	7	6	6
Community and Regional Development Aid	7	6	5	5
Employment and Training Assistance	9	8	4	4
Urban Mass Transit	3	4	4	4
Wastewater Treatment	4	4	4	3
Social Services	3	2	2	2
Health Grants	2	2	2	2
Energy Assistance	2	2	2	2
All Others	7	8	8	8
Total	52	52	45	44

or to finance specific services not generally available. In other cases, the federal funds merely increase the level of already-available state and local services. Funding for nonentitlement grants was cut back sharply during the 97th Congress, reducing outlays from $52 billion in 1980 to $45 billion in 1982, with a further $1 billion decline expected in 1983.

Spending for state and local grants could be reduced still further either by shifting responsibility for selected programs to state and local governments or by reducing funding for less needy areas or populations. Such cutbacks would lower federal outlays, but they would place additional financial strains on states and localities. Because these governments are suffering the consequences of the current recession and earlier funding reductions, many jurisdictions would have difficulty replacing federal funds, at least in the short run. To the extent that states and localities increased their own revenue-raising efforts to compensate for federal cutbacks, the total cost of government at all levels would remain unchanged, although the distribution of those costs would be altered.

The examples of grant reductions discussed below and summarized in Table VII-4 cover transportation, education, community and economic development, environmental services, the administration of justice, and social services.

Require Cost-Sharing for Future Funding Increases. The federal role in financing public services could be reduced by requiring that states and localities share the burden of funding increases in selected grants. This approach would ensure that increased federal funding went only for those services valued sufficiently to induce jurisdictions to contribute a share of any additional costs. On the other hand, many governments, because of their weakened fiscal condition, would be hard pressed to meet the matching requirements--potentially leaving the additional federal assistance out of reach of those states and localities most in need.

One example of such an action would be to increase funding for selected state and local grants by one-half the expected rate of inflation, on the condition that recipient jurisdictions match the added federal funds with a like amount of their own resources. If this strategy was adopted beginning in 1984 for the principal education, employment and training, nutrition, and community development programs, for example, savings relative to the full-inflation baseline would amount to about $150 million in that year, rising to $1.5 billion by 1988. These savings are calculated assuming that all states and localities would match the federal funding increases. If any jurisdictions failed to provide matching funds, federal savings would be greater, but the amount of additional services provided would be less.

Reduce and Refocus Federal Highway Funding. The federal government--in partnership with states--finances the construction and repair of highways and bridges. The federal contribution was $8.4 billion in 1982 and will grow to $15.6 billion by 1988 if current policies are continued--primarily because of the recently enacted 5-cents-per-gallon motor fuels tax increase, 4 cents of which is to be used for highways. State expenditures for these same roads totaled $6.1 billion in 1982, of which $1.6 billion was required to match the federal contribution.

Over the years, the federal-state partnership in financing the construction of highways has grown to include more locally oriented segments of the nation's road network, such as beltways and other local routes. As a result, today, only two-thirds of federal highway funds are spent for the two most nationally oriented road systems (the Interstate and Primary systems), compared with 90 percent just 15 years ago.

Substantial savings could be achieved by gradually limiting the federal highway program to its original emphasis on intercity arteries. The largest

TABLE VII-4. BUDGET SAVINGS FROM REDUCTIONS IN STATE AND LOCAL GRANTS (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Require Cost-Sharing for Future Funding Increases						
Budget Authority	490	790	1,150	1,510	1,880	5,820
Outlays	150	400	750	1,110	1,470	3,880
Reduce Interstate Highway Funding						
Budget Authority	3,000	3,000	3,000	3,000	3,000	15,000
Outlays	510	2,070	2,520	2,670	2,760	10,530
End Federal Aid for Urban and Secondary Roads						
Budget Authority	1,450	1,450	1,450	1,450	1,450	7,455
Outlays	250	975	1,195	1,275	1,365	5,060
Reduce Federal Mass Transit Aid						
Budget Authority	1,200	1,220	1,240	1,290	1,340	6,290
Outlays	900	960	1,040	1,140	1,260	5,300
End Airport Assistance for Facilities Not Serving National Needs						
Budget Authority	440	435	450	450	465	2,240
Outlays	90	285	375	420	450	1,620
End Assistance for Financially Self-Sufficient Airports						
Budget Authority	190	185	195	195	200	965
Outlays	40	125	160	185	195	705

(Continued)

TABLE VII-4. (Continued)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Reduce and Reallocate Elementary and Secondary Education Aid						
Budget Authority	250	265	280	295	310	1,400
Outlays	20	165	260	275	290	1,010
Reduce and Redirect Vocational Education Assistance						
Budget Authority	260	270	285	300	315	1,430
Outlays	35	190	265	285	300	1,075
Reduce Eligibility for Community Development Block Grants						
Budget Authority	722	758	792	823	854	3,949
Outlays	14	289	679	769	802	2,553
Further Limit Eligibility for Urban Development Action Grants						
Budget Authority	115	121	127	132	136	631
Outlays	24	45	71	98	126	364
Terminate Funding for Juvenile Justice and Delinquency Programs						
Budget Authority	74	77	81	84	88	404
Outlays	17	51	72	80	84	304
Target Administration on Aging Programs						
Budget Authority	70	75	80	80	85	390
Outlays	50	65	75	80	85	355

savings would come from redefining the Interstate system to include only projects that serve interstate commercial and passenger travel. At present, locally oriented routes account for more than half of the $39 billion (in 1979 dollars) needed to complete the remaining 1,500 miles of the Interstate system. Focusing federal dollars on Interstate routes of national significance would reduce outlays by $10.5 billion over the next five years alone. Returning financial responsibility for urban and secondary roads to state governments would reduce federal spending by an additional $5.1 billion over the next five years. On the other hand, withdrawing federal support for such routes would involve breaking commitments of many years' standing and would force either substantially greater state and local expenditures or the curtailment of some construction and repair work. The added burden on states could be reduced somewhat by providing them with a portion of the revenues from the recent increase in the federal motor fuels tax, but this would also reduce the federal budgetary savings.

Reduce Federal Mass Transit Aid. The development and operation of mass transit systems represents another area of shared federal-nonfederal financial responsibility in which federal outlays could be reduced by shifting a greater proportion of the total costs to states and localities. At present, the federal government provides 75 to 80 percent of the cost of capital projects and, on average, 15 percent of operating costs--involving total outlays of $2.8 billion for capital and $1.0 billion for operations in 1982. In the future, $1.1 billion per year in revenues generated by 1 cent per gallon of the recently enacted motor fuels tax increase will be available for capital expenditures, in addition to the regularly appropriated funds. Federal operating subsidies, by contrast, are slated to decline by 16 percent between 1982 and 1983 as a result of the most recent appropriations actions.

It can be argued that little rationale exists for lending national taxpayer support to local transit operations, because the principal benefits are realized locally. On the other hand, transit systems may also offer significant regional benefits, as instruments of economic development and as means of avoiding downtown congestion.

One specific option for reducing the federal role would be to lower the federal share of capital costs to two-thirds--and reduce federal spending accordingly--while withdrawing all operating subsidies. Together, these changes would result in outlay savings of $5.3 billion over the 1984-1988 period. Such a cutback in capital assistance would increase the burden on states and localities but would also encourage them to apply more stringent economic criteria to potential investments, severely discouraging new capital-intensive transit systems such as subways. Ending federal operating subsidies would result either in increased locally financed subsidies or in increased fares. Indeed, without federal operating subsidies, some small cities that do not depend heavily on public transit would probably end service entirely.

Reduce Federal Airport Assistance. Appreciable savings could be realized by withdrawing federal grants from airports that do not substantially serve national transportation objectives. Currently, some 780 commercial facilities and 2,379 general aviation facilities--serving owners of small planes in corporate and recreational use--receive grants in aid for airport development. Under current policies, these airports would receive approximately $1 billion in grants annually over the next five years for improvement and expansion projects. However, only 66 of the commercial airports--less than 10 percent of the total--serve virtually all of the nation's commercial airline traffic. Moreover, only 155 of the general aviation airports receiving federal aid are needed to help reduce congestion at the major commercial airports. Withdrawing federal support from all airports that serve only locally oriented aviation activities would reduce federal outlays by $1.6 billion over the next five years. Terminating federal aid could, however, cause short-term disruptions for small commercial carriers and general aviation users.

Further savings could be achieved by targeting funds more narrowly on the least self-sufficient facilities. Even after eliminating aid for all airports not serving national transportation objectives, funds would still be available to many facilities that are financially self-sufficient and generally able to meet their debt-service requirements from landing fees, terminal concessions, and parking charges. If assistance was also withdrawn from such self-sufficient facilities, approximately 25 additional airports would no longer be eligible for aid at an added five-year outlay savings of $705 million.

Reduce and Reallocate Elementary and Secondary Education Aid. The 1981 Reconciliation Act created the Chapter II elementary and secondary education block grant by consolidating more than 20 separate categorical programs. In contrast to its predecessor programs, Chapter II funds are generally not targeted on specific groups of children or on specific educational services, although some states are attempting to maintain targeting of some of the funds for children formerly served by Emergency School Aid--the largest of the earlier programs. Because Chapter II funds are distributed on the basis of the school-age population, they are not targeted by the financial need of the recipient school districts. Funded at $479 million in 1983, Chapter II grants account for about one-half of one percent of all funds spent on public elementary and secondary education.

Federal savings could be achieved by eliminating the Chapter II program while shifting some of the money saved to more targeted programs. If, for example, the Chapter II program was terminated in 1984 and 50 percent of the Chapter II funds were shifted to the Chapter I compensatory education program, which finances services to the educationally disadvantaged, savings over the 1984-1988 period would total $1 billion. Such a change might increase federal assistance to disadvantaged students but would lower total education aid at a time when many school districts are experiencing severe financial strains.

Reduce and Redirect Vocational Education Assistance. Federal support for vocational education could be reduced by targeting support more narrowly on disadvantaged students. Although $722 million has been appropriated in 1983 to help states finance vocational education efforts, only about 30 percent of the federal funds are earmarked by federal law for disadvantaged students, including the handicapped, the economically disadvantaged, and students with limited proficiency in English. Furthermore, the federal funds constitute less than 10 percent of total federal, state, and local expenditures for vocational education.

Eliminating the untargeted federal contribution and using half of the money saved to increase funding for disadvantaged students would reduce federal outlays by about $1.1 billion over the next five years. Such a shift would increase explicitly targeted federal assistance but would diminish total support for vocational education by one-third.

Reduce Eligibility for Community Development Block Grants. Funding for the large cities and urban counties component of the Community Development Block Grant (CDBG) program could be reduced by providing aid only to the needier jurisdictions. Currently, all metropolitan cities and urban counties are entitled to funds, although needier jurisdictions receive larger grants per capita. CDBG funds are used at the recipients' discretion for a wide range of development activities, including housing rehabilitation, street and sewer repair, and recreational facilities funding. It can be argued, on the one hand, that such activities are properly the responsibility of local governments and that no pressing interest is served by funding them at the national level--particularly for jurisdictions that have above-average capacity to finance such projects themselves. On the other hand, most CDBG funding benefits low- and moderate-income households that might not be served in the absence of federal funds. Eliminating the least needy cities and counties and reducing CDBG funding by 20 percent would lower federal outlays by approximately $2.5 billion over the next five years, while retaining aid for the most distressed jurisdictions.

Further Limit Eligibility for Urban Development Action Grants. Funding for the Urban Development Action Grant (UDAG) program could also be reduced by further limiting eligibility. The UDAG program provides grants to local governments to support private development projects in economically distressed areas. Supported projects include commercial development such as offices or hotels, as well as industrial projects and housing. As of 1981, UDAG grants provided, on average, 12 percent of planned project costs; the private sector contributed 81 percent, and other public sources added the remaining 7 percent. On the one hand, it can be argued that the benefits of economic development generated by the UDAG program are local in nature, and that such activities should be funded at the level at which the benefits are generated. On the other hand, UDAG projects are located in distressed areas, which might not have the resources to participate in such projects without federal aid. If the one-fourth least severely distressed jurisdictions now eligible under the UDAG program were eliminated and federal funds were cut by a like amount, federal savings of more than $360 million could be realized over the next five years without cutting aid to the neediest governments.

Terminate Funding for Juvenile Justice and Delinquency Programs. Currently, the federal government provides approximately $70 million annually to states to support research, education, training, and related efforts in the juvenile justice and delinquency area. Opponents of such assistance argue that federal funds add little to state and local efforts, and that states and localities are best able to assess their needs in this area without federal direction and control. Opponents also note that ineffective program monitoring and evaluation further limit the value of federal aid. Proponents of continued federal assistance contend that the high rates of youth crime make federal support important. They point out that, despite certain administrative problems, activities funded under these programs have been successful in achieving some of the statutory objectives--notably in demonstrating less costly and more effective methods for dealing with juvenile offenders. Terminating juvenile justice and delinquency grants would reduce federal outlays by about $300 million over the next five years.

Target Administration on Aging Programs. The Administration on Aging within the U.S. Department of Health and Human Services funds a variety of nutritional and social services for the elderly through grants to state governments. Although the Congress has specified that programs funded through these grants are not to be means-tested, about 60 percent of the $636 million distributed in 1982 was eventually used to benefit individuals with incomes below the poverty line. In addition, although no payments are required from participants, increasing amounts have been recouped since 1979 through voluntary contributions from the elderly persons using the services. In 1982, these contributions totaled about $100 million, which was used by state agencies to increase the volume of services provided.

Reducing funding by 10 percent, while imposing a means test for free participation, would lower federal outlays by more than $300 million over the 1984-1988 period, while protecting the benefits of the neediest participants. This change, however, would entail substantial administrative costs, since a mechanism for assessing participants' incomes would need to be established and maintained. Moreover, the means test could discourage participation, even by some needy individuals.

Assistance to Business and Commerce

The federal government provides assistance to business and commerce through a broad array of programs involving direct expenditures, subsidized credit, loan guarantees, and information. Among the largest of these programs are agricultural credit assistance efforts, aid to exporters, assistance to small businesses, and subsidies to specific industries, such as shipowners. On-budget outlays for assistance to business and commerce totaled approximately $7 billion in 1982 and are expected to remain at about that level in 1983.

Business assistance programs often developed either because particular markets were perceived as not meeting the needs of certain groups or because desired public benefits coexisted with the private benefits. Once initiated, however, many programs acquire an institutional inertia that can keep them alive long after their original purposes have been realized. In the 1930s, for instance, the Congress created the Rural Electrification Administration (REA) to finance electrical power development in areas not adequately served by private financing sources; such aid continues today although rural areas are now better integrated into national credit markets.

Substantial savings could be realized by curtailing private-sector subsidies that no longer convey substantial public benefits. This could be accomplished by eliminating programs outright, or, in the case of credit programs, by raising the interest rates charged on loans. The examples described below and summarized in Table VII-5 cover several industries and sectors of the economy.

Terminate Operating Subsidies for the Maritime Industry. The Maritime Administration, a unit of the Department of Transportation, currently assists the U.S. maritime industry through operating assistance for shipowners. Foreign carriers operate at about two-thirds the costs of U.S. ships. Thus, the U.S. maritime industry, as currently constituted, is no longer competitive in world markets. Proponents of continued federal assistance argue that, because most other nations subsidize their merchant marines,

TABLE VII-5. BUDGET SAVINGS FROM REDUCTIONS IN ASSISTANCE TO BUSINESS AND COMMERCE (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Terminate Operating Subsidies for the Maritime Industry						
Budget Authority	427	448	467	485	503	2,330
Outlays	425	445	464	483	501	2,318
Terminate Funding for Overseas Agricultural Market Development						
Budget Authority	41	43	44	45	47	220
Outlays	28	39	44	45	46	202
Reduce Export-Import Bank Aid						
Budget Authority	3,389	3,753	3,878	3,978	4,567	19,565
Outlays	334	1,608	2,614	2,971	2,934	10,461
End Selected SBA Business Loans						
Budget Authority	160	130	105	80	60	535
Outlays	155	125	105	80	60	525
Raise Interest Rate on REA Loans [a]						
Budget Authority	6	23	48	70	90	237
Outlays	6	23	48	70	90	237
Eliminate REA Loan Guarantees [a]						
Budget Authority	---	1,740	2,950	3,820	4,460	12,970
Outlays	---	1,740	2,950	3,820	4,460	12,970
Raise Interest Rate on FmHA Loans to Limited-Resource Farmers						
Budget Authority	---	20	45	65	90	220
Outlays	---	20	45	65	90	220

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a. Savings from these options result from the borrowings of the Federal Financing Bank and thus appear off-budget.

parallel American aid is needed. It is also argued that a domestic maritime industry is essential on national security grounds. Opponents of operating subsidies note that, even in the absence of such aid, shipowners would continue to benefit from laws that reserve certain shares of American cargo trade to U.S. flag vessels. Moreover, continued subsidies may promote higher labor costs as well as operating inefficiencies. Eliminating operating subsidies would reduce federal outlays by $2.3 billion over the 1984-1988 period.

Terminate Funding for Overseas Agricultural Market Development. Since 1954, the federal government has supported efforts to develop foreign agricultural markets through planning assistance in this country and through offices overseas. This support has been premised on the notion that aiding domestic producers to develop overseas markets could boost exports, help the U.S. balance of trade, and increase farmers' incomes. Once the markets have been developed and the overseas potential demonstrated, however, federal support is no longer clearly needed. Agricultural producers and exporters, it is argued, should have adequate incentives to pursue foreign markets on their own. Others note that shifting such market-development expenses back to private producers would place additional strains on an already-pressed sector of the economy. Eliminating federal funding for foreign market development in 1984 would save a total of about $200 million over the 1984-1988 period.

Reduce Export-Import Bank Aid. The Export-Import Bank (Eximbank) provides direct loans and loan guarantees to promote exports of U.S. goods and services. The direct loan program is intended to increase exports by providing loans at below-market rates of interest to finance foreign purchases of U.S. goods. The loan guarantee program aims at encouraging commercial banks to extend export credit loans by reducing the risk inherent in export financing. These guarantees are attractive because interest rates charged on such guaranteed loans are among the lowest available in the market.

Federal export credit programs are aimed at increasing employment and output in the United States. They do so to the extent that they encourage consumption--and, therefore, production--of U.S. goods that would not have otherwise taken place. Opponents of export subsidies argue, however, that a substantial portion of Eximbank aid goes to industries in which U.S. firms enjoy near monopolies, therefore only subsidizing consumption in the importing nation rather than promoting additional exports. Proponents of Eximbank programs argue that they are necessary to counter export subsidies provided by other nations that displace potential U.S. exports. Savings of $10.5 billion could be realized over the next five years if direct loans were eliminated entirely and if loan guarantees were provided to only those industries that truly face subsidized competition, such as electronic equipment and machine tools.

End Selected SBA Business Loans. The Small Business Administration (SBA) provides direct loans to small businesses unable to secure conventional financing--promoting business development generally and aiding economically and socially disadvantaged groups. The loans are written at an interest rate equal to one percentage point above the average yield on outstanding marketable obligations of the U.S. government with comparable maturities. Proponents of SBA assistance argue that such aid is justified because small businesses generally create more jobs, improve technology more rapidly, and satisfy some markets more efficiently than do large firms. Others note that these benefits do not necessarily flow from all small businesses. Indeed, because SBA limits its direct loans to firms that cannot obtain conventional financing from private lenders, the aid may go to the firms least likely to create stable employment, improve technology, or enhance national productivity. Another consequence of the SBA's selection criteria has been a default rate of nearly 10 percent. Eliminating all SBA direct business loans, other than for disaster assistance and for the Minority Enterprise Small Business Investment Companies program, would reduce net federal outlays by $525 million over the 1984-1988 period.

Raise Interest Rates on REA Loans and Curtail Loan Guarantees. As mentioned above, the Rural Electrification Administration was established more than 40 years ago to help finance the extension of electrical service to rural areas. Today, however, 99 percent of the nation's farms have access to electricity and 95 percent have access to telephones. Nonetheless, the REA continues to provide loans at 5 percent interest to rural electrical and telephone cooperatives through a revolving fund that is financed largely off budget. The REA also provides loan guarantees (in effect, direct loans as well) at the Treasury's cost of funds plus 0.125 percent interest.

Although a 5 percent interest rate for direct loans did not represent a significant subsidy when the current revolving fund was established in 1973, at today's federal borrowing costs it entails a sizable subsidy in pursuit of a public policy objective that has been largely realized. The $1.1 billion in direct REA lending in 1982, for example, will cost the fund about $3 billion over the lives of the loans. As a result of these costs, the fund's resources for absorbing interest subsidies may be exhausted by the mid-1980s under current policy. Raising the interest rate on new direct REA loans to the Treasury's borrowing costs plus 0.125 percent--the same rate as on the so-called guaranteed loans--would restore solvency to the direct loan fund while reducing long-term federal interest-subsidy costs by more than $1.3 billion for each $1 billion in new lending at 1983 interest rates. Outlay savings relative to the CBO baseline would total more than $200 million through 1988, with the savings appearing outside of the unified budget totals because REA activities are financed through transactions with the off-budget Federal Financing Bank. While raising the interest rate on REA loans would increase cooperatives' borrowing costs, it would leave their financing expenses well below those faced by investor-owned utilities.

REA guaranteed loans--unlike direct loans--do not involve interest-subsidy costs for the government. The guaranteed loans do, however, entail off-budget outlays, because they are made by the Federal Financing Bank, with offsetting repayments spread out over many years. In addition, the guarantee exposes the government to sizable risks in the event of defaults. The guaranteed loans--a minimum of $5 billion of which are provided annually under current law--are used primarily for electrical generating facilities, such as nuclear power plants. Many of these are projects jointly owned by REA cooperatives and investor-owned utilities--providing those utilities with a financing source not available to companies not developing projects in concert with REA cooperatives. Eliminating the loan guarantee program would reduce federal exposure by more than $30 billion over the next five years and would lower off-budget outlays by $13 billion through 1988. Lowering the $5 billion annual loan guarantee minimum while maintaining the program would, of course, reduce exposure and outlays somewhat less. Any rapid cutbacks in these programs could, however, cause financial hardships for some rural cooperatives while raising costs for their customers.

Raise Interest Rate on FmHA Loans to Limited-Resource Farmers. To encourage new entrants into farming, the Farmers Home Administration (FmHA) provides reduced-interest loans to young farmers who, for various reasons, are not deemed creditworthy by commercial banks. Current law requires that at least 20 percent of FmHA's farm loans go to such limited-resource farmers. Under current law, real estate loans are provided at one-half the government's borrowing cost, but no less than 5 percent interest; operating loans are provided at an interest rate fixed at five percentage points below the government borrowing rate, but no less than 5 percent.

If borrowers under these programs lack access to private credit because of inappropriate market judgments by private lenders rather than because the borrowers lack potential as farmers, federal credit at market interest rates might be sufficient to meet their credit needs. Interest subsidies may attract persons who are in fact not creditworthy and who will become dependent on continuing direct federal aid. Raising the interest rate on new loans to the Treasury's cost of funds beginning in 1984 would save about $220 million over the 1984-1988 period, while appreciably increasing costs for potential entrants into farming.

Benefits and Services to Individuals

The federal government finances benefits and services to individuals (such as income support, nutrition assistance, health care, and education) through the large entitlement programs discussed elsewhere in this report, through the state and local grants discussed earlier in this chapter, and through appropriated programs directly administered by the federal government. Federally administered nonentitlement benefit programs include veterans' health care, housing assistance, and aid for college students. On-budget outlays for such programs totaled about $25 billion in 1982--up from $23 billion two years earlier--and are due to rise to $28 billion in 1983.

Federal expenditures in this area could be reduced either by curtailing aid for all current recipients or by targeting assistance more narrowly on the most needy individuals. Four examples of program cutbacks are described below and summarized in Table VII-6.

Require Copayments for VA Health Care. The cost of health care provided through the Veterans Administration (VA) could be reduced by requiring copayments for hospital care offered to some persons without service-connected disabilities. Many believe that the VA's primary responsibility is to provide medical care to veterans with service-connected disabilities. Today, however, over 70 percent of the recipients of free VA hospital care have no service-connected injuries or illnesses.

Some persons contend that establishing deductibles and coinsurance requirements for nonservice-disabled veterans would be a logical way of containing increases in VA health care costs, while decreasing the preference that some veterans show for VA care over care in private facilities. This, in turn, would help ensure that VA-provided services would continue to be adequate to meet the needs of service-disabled veterans as the demand for VA health services increases with the aging of the veteran population. Since over 40 percent of the nonservice-disabled group using VA services are poor or have no public or private health insurance, however, some would argue that such veterans should be exempt from any cost-sharing arrangements. Establishing copayment requirements, equivalent to those under Medicare for the first 90 days of inpatient care, for all nonpoor veterans without service-connected disabilities and with health insurance could reduce five-year VA outlays by $1.3 billion.

Reduce Campus-Based Student Assistance. Savings could be achieved in postsecondary student aid programs by reducing funding for three programs administered at the campus level--College Work-Study, National Direct Student Loans, and Supplemental Educational Opportunity Grants. In

TABLE VII-6. BUDGET SAVINGS FROM REDUCTIONS IN BENEFITS AND SERVICES TO INDIVIDUALS (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Require Copayments for VA Health Care						
Budget Authority	160	190	245	300	355	1,250
Outlays	160	190	245	300	355	1,250
Reduce Campus-Based Student Assistance						
Budget Authority	170	175	185	195	205	930
Outlays	10	160	175	185	195	725
Reduce Rural Housing Subsidies						
Budget Authority	85	140	195	250	310	980
Outlays	85	140	195	250	310	980
Reduce Subsidies for the Arts and Humanities						
Budget Authority	58	61	63	65	68	315
Outlays	31	60	62	64	67	284

1982, these programs provided $1.1 billion to assist between 1 and 2 million students, some of whom also received aid under the larger Guaranteed Student Loan and Pell grant programs. Reducing funding for the campus-based programs by 15 percent would result in five-year savings of $725 million. The number of students affected by such a cutback would depend on actions taken by program administrators at colleges and universities. Consolidating the three campus-based aid programs into a single block grant would increase administrators' discretion in allocating remaining funds but would not result in administrative savings sufficient to make up for the funding decrease.

Reduce Rural Housing Subsidies. The major rural housing assistance programs administered by the Farmers Home Administration provide about $3.3 billion of reduced-interest loans annually to finance single-family and multifamily housing for low-income households. In the single-family assistance programs, interest rates are set so that borrowers spend 20 percent of their income on mortgage principal and interest payments plus taxes and insurance. In the multifamily assistance programs, developers receive mortgages at 1 percent interest, and tenants pay a minimum of 25 percent of their incomes for rent.

The costs of these programs could be reduced by requiring that assisted households pay larger shares of their housing costs. If new single-family borrowers were required to pay 25 percent--rather than 20 percent--of their incomes for principal, interest, taxes, and insurance, for example, federal outlays would fall by $855 million over the next five years, while borrowers' housing expenses would rise by roughly one-fourth. Increasing the minimum tenant rent payments in multifamily projects from 25 percent to 30 percent of income would reduce five-year outlays by $125 million. It would also ensure more nearly equal treatment of households receiving FmHA assistance and those aided by the Department of Housing and Urban Development, which already has a standard of 30 percent of income for new tenants. An alternative approach to reducing federal outlays would, of course, be to lower the volume of new loans made annually.

Reduce Subsidies for the Arts and Humanities. In 1982, the federal government provided approximately $270 million in subsidies for the arts and humanities through the National Endowment for the Arts and the National Endowment for the Humanities--down from $310 million the year before. Almost all grants by the Endowments require matching by recipients, at rates ranging from 90 cents to $3 per federal dollar. The proportion of funds to be obligated at each matching rate is set by law, and currently about three-fourths of the Endowments' funds require the lowest matching rates: 90 cents or $1 per federal dollar.

Reducing funding for the Endowments by 20 percent would lower federal outlays by almost $300 million over the next five years. The impact of such a cut on beneficiaries might be lessened by shifting a larger proportion of remaining funds into grant categories requiring higher matching rates. Under present conditions, however, the potential for increased contributions from nonfederal sources is probably limited.

Infrastructure, Environment, and Related Services

The federal government finances the development and maintenance of the public infrastructure (transportation networks, sanitation systems, and the like), the protection of the environment, and related services through state and local grants discussed earlier in this chapter, and through programs funded and administered directly by the federal government. The principal federally administered programs--discussed in this section--include environmental and natural resource programs, transportation programs, and community and regional development aid. Outlays for these programs totaled $18 billion in 1982--down from $19 billion in 1980. Expenditures are estimated to rise to $20 billion in 1983.

The primary rationale for these programs is that they provide services essential to the productive operation of the economy (such as an inland waterway system) or convey benefits the private market would not necessarily offer (such as pollution abatement). In some instances, however, the benefits may not outweigh the costs, or may be highly localized. Identifying such programs and reducing their funding could result in substantial budgetary savings (see Table VII-7).

Terminate Less Cost-Effective Bureau of Reclamation Water Projects. In 1902, the Bureau of Reclamation within the Department of Interior began building and operating water projects for irrigation, hydropower, and other uses. The bureau's mission was to help settle the West by stimulating local economies with inexpensive, federally subsidized water and power. After 80 years, however, that mission is largely satisfied--the West is settled and most of the obviously beneficial water projects have already been built. Today, federal subsidies--which have totaled between $500 million and $700 million annually during the 1970s and 1980s--charge general taxpayers for building projects that small groups of beneficiaries would probably be unwilling to pay for if they were assessed their full cost. Although some of the projects currently under construction will probably yield benefits in excess of costs, others may not.

Terminating currently authorized and ongoing projects with benefit-to-cost ratios less than 1.3 (calculated at lower than current interest rates) would save about $1.5 billion over the next five years. If local beneficiaries judged these projects to be economically sound, other sources of financing--including tax-exempt revenue bonds--could substitute for federal subsidies. The revenue loss from such bond financing would, however, offset some of the savings from cutting back direct expenditures. If federal subsidies were eliminated, beneficiaries of locally financed projects--primarily western farmers and users of hydroelectric power--could be required to pay up to five times more than they currently do for water and up to 50 percent more for power.

Terminate Maintenance Dredging for Less Cost-Effective Waterways and Ports. The U.S. Army Corps of Engineers maintains the nation's system of inland waterways, ports, and harbors. In 1982, the Corps spent about

TABLE VII-7. BUDGET SAVINGS FROM REDUCTIONS IN INFRASTRUCTURE, ENVIRONMENT, AND RELATED SERVICES (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Terminate Less Cost-Effective Bureau of Reclamation Water Projects						
Budget Authority	300	300	300	300	300	1,500
Outlays	260	300	300	300	300	1,460
Terminate Maintenance Dredging for Less Cost-Effective Waterways and Ports						
Budget Authority	200	200	200	200	200	1,000
Outlays	160	200	200	200	200	960
Reduce Funding for Amtrak						
Budget Authority	280	300	310	320	330	1,540
Outlays	280	300	310	320	330	1,540

$800 million for this purpose, of which only about $40 million was recovered from a 6-cents-per-gallon fuel tax on waterborne traffic. Operation and maintenance expenditures are made regardless of the traffic that benefits from such an investment. If maintenance dredging was terminated for all shallow-draft harbors, seven high-cost/low-volume waterways, and 55 high-cost/low-volume deep-draft ports, about $200 million could be saved annually over the next five years. While dredging would be available on the private market if local jurisdictions judged their projects worthy of investment, having to bear such costs without federal aid could cause severe economic dislocations for some localities.

Reduce Funding for Amtrak. Amtrak was founded in 1970 to ensure continuing intercity rail passenger service as private providers withdrew.

The Congress initially funded it with the intention that it should be self-sufficient after one year. Over time, however, Amtrak's subsidy rose, with federal aid now covering all capital costs and one-half of all operating costs. In 1982, the federal subsidy totaled $735 million. Analysis of Amtrak indicates that it provides few of the public benefits claimed for it at a high cost: in 1980, Amtrak received 31 percent of net federal transportation expenditures, yet carried less than 1 percent of all intercity passenger traffic. In the same year, Amtrak received 23.6 cents per passenger mile in net federal subsidies, compared with the 0.2 cent net federal subsidy provided to commercial aviation and the 0.1 cent net subsidy that went to passenger cars and intercity buses. 4/

One means of reducing Amtrak's subsidy would be to eliminate routes that have low ridership and dim future prospects. If the Amtrak system was limited to routes on which ridership is strongest and for which the prospects for improved ridership and better financial performance are greatest--located primarily in the Northeast Corridor, along part of the West Coast, and on certain routes around Chicago--the federal subsidy would decline by $1.5 billion over the 1984-1988 period.

Research and Development

The federal government supports numerous research and development (R&D) efforts that encompass a broad range of activities from the search for new knowledge--or basic research--to the commercialization of improved products and processes. Basic research plays a special role in developing a knowledge base upon which scientific and technological breakthroughs are built. Commercial development is more concerned with promoting the application of the results of basic research to social and economic outcomes. In 1982, the federal government spent $16 billion for R&D, other than that financed through defense agencies. 5/ Of that total, $6 billion went for space and aeronautical research and exploration, $3.9 billion for energy R&D, and $3.6 billion for health research.

While both the private sector and the government support R&D, their underlying purposes often differ. Because much R&D--particularly more speculative basic research--involves long-term investments whose full benefits may not be easily captured by the party financing the work, private

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4. For further analysis, see Congressional Budget Office, Federal Subsidies for Rail Passenger Service: An Assessment of Amtrak (July 1982).

5. R&D spending by defense agencies is dealt with in Chapter II.

entities may be reluctant to invest in such endeavors. Government, by contrast, can afford to wait longer to realize the benefits of research and is concerned with benefits that accrue to the public at large, rather than to private parties. On the other hand, because government lacks market feedback and does not have the same financial constraints as businesses, it may be at a relative disadvantage in carrying out commercialization efforts.

The differing perspective of the private and public sectors suggests one strategy for reducing federal R&D spending--focusing budget cuts on those projects near the development and commercialization end of the R&D spectrum, thereby freeing more funds for basic research. The examples described below and summarized in Table VII-8 are concentrated in the energy and applied aeronautics areas.

TABLE VII-8. BUDGET SAVINGS FROM REDUCTIONS IN RESEARCH AND DEVELOPMENT (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Terminate Funding for the Clinch River Breeder Reactor						
Budget Authority	180	215	225	235	250	1,105
Outlays	105	190	220	230	245	990
Abolish the Synthetic Fuels Corporation						
Budget Authority	---	---	---	---	---	---
Outlays	21	22	23	24	25	115
Reduce NASA's Aeronautical Research						
Budget Authority	105	110	120	125	130	590
Outlays	40	100	110	120	125	495
Refocus the Work of the National Laboratories						
Budget Authority	550	575	600	625	650	3,000
Outlays	275	565	590	615	640	2,685

Terminate Funding for the Clinch River Breeder Reactor. The Clinch River Breeder Reactor (CRBR) is a joint government-industry project originally intended to demonstrate that nuclear reactors that make highly efficient use of the uranium ore base could be licensed and operated commercially. When first proposed in 1972, the CRBR was estimated to cost $700 million, of which the private nuclear industry was to pay $300 million. Since then, cost estimates have grown to more than $3 billion, while the private contribution has remained unchanged. As costs have grown, questions have also arisen regarding the need for early commercialization--most estimates of the supply and demand for nuclear fuel suggest that the breeder would not become economic until the 2020-2030 time period. Terminating funding for the CRBR would save $105 million in 1984 and a total of $1.0 billion between 1984 and 1988. Loss of this project could, however, erode the long-term competitive position of the U.S. nuclear industry, if breeder reactors become economic at an earlier time.

Abolish the Synthetic Fuels Corporation. Synthetic fuels--substitutes for oil and gas products--are extracted from more plentiful resources such as coal and oil shale. The Synthetic Fuels Corporation (SFC), an independent federal entity, was created in 1980 to assist the private sector in developing a number of commercial-sized synthetic fuel plants. The SFC, with $12.2 billion in budget authority granted before 1983, functions primarily as an investment bank. It is authorized to provide loan guarantees, price guarantees, purchase agreements, and direct loans. In exceptional circumstances, the SFC may participate in joint ventures with private firms.

The rationale for SFC subsidies rests on long-term energy security concerns--the need to develop technologies to convert abundant domestic resources into energy products that could eventually displace imported oil. However, the recent decontrol of oil and the impending decontrol of natural gas, together with a general softness in world oil prices, has reduced the urgency of such development. Under these circumstances, full funding for the SFC may no longer be needed. On the other hand, continuing the SFC might provide some insurance against the effects of a future interruption in foreign oil supplies and could help maintain the synthetic fuel industry should oil prices rise again. SFC proponents also argue that the United States will eventually have to make the transition to synthetic fuels and that the experience provided by early plants will be helpful in choosing the appropriate technologies. If the SFC was abolished in 1984, five-year savings would amount to more than $100 million, with eventual savings totaling several times that.

Reduce NASA's Aeronautical Research. The aeronautical research and technology section of the National Aeronautics and Space Administration (NASA) is authorized to spend approximately $300 million each year to improve various facets of aircraft flight and to ensure that the United States maintains its technological superiority in the field of aeronautics. However, NASA has centered much of its effort around aircraft performance and fuel mileage--two areas in which private industry does a great deal of research and development. Funding for such programs could thus probably be cut at little risk and the remainder of the high-speed aircraft R&D effort transferred to the Department of Defense, since most of the research in these programs would be used for military applications. The programs left in aeronautical research after these cuts would deal primarily with safety and long-term speculative questions.

These cuts in NASA's budget would save almost $500 million through 1988. Since fuel efficiency and performance are important factors in the number of aircraft that manufacturers sell, incentives exist for private research to be done in these areas. Without NASA, however, domestic manufacturers might eventually have difficulty maintaining their current margin of technological superiority over foreign competition. Moreover, while private industry has the incentive to continue much of the research in aircraft performance and fuel efficiency, fewer incentives exist for industry to take up NASA's efforts in the areas of particulate and noise emission.

Refocus the Work of the National Laboratories. More than $4 billion of the federal civilian R&D funds is spent annually in the government's "intramural" facilities--the national multipurpose laboratories and agencies' in-house laboratories. This national laboratory complex developed as an outgrowth of specific national needs. The multipurpose laboratories under Department of Energy jurisdiction, for example, grew from the Manhattan Project, and were formalized and expanded under the Atomic Energy Commission. The atomic bomb project led naturally to the specific needs for research in radiation biology and more generally in all of the physical sciences. As their missions expanded, the national laboratories became focal points for making large research facilities available to universities and industry, for assisting other federal agencies, and for acting generally to link technological areas.

Some concern now exists that in many cases the laboratories may be performing research in competition with the private sector, conducting research that may be inappropriate for federal government activity, or being used inefficiently. Savings might be achieved by reorganizing, consolidating, or eliminating some of the functions of the national laboratories, and refocusing their efforts on basic research. For example, cutting applied and development (potentially commercial) research by one-half while doubling basic research would result in five-year savings of approximately $2.7 billion. Such a shift might, however, weaken the national scientific infrastructure in which the national laboratories play an important role.

Aid to Foreign Governments and International Organizations

The United States aids developing countries through economic and security assistance programs consisting of outright grants or reduced-interest loans. Economic assistance programs include bilateral aid such as Public Law 480 food aid, which provides agricultural commodities for distribution abroad and finances sales of U.S. agricultural exports; Agency for International Development programs; and multilateral assistance programs, including contributions to the World Bank, the Inter-American and Asian Development Banks, and various agencies of the United Nations. Security assistance includes the Economic Support Fund (ESF) programs, which provide assistance to promote political and economic stability, and military assistance through training grants and the financing of sales of military equipment and services. Net outlays for all aid programs totaled $8 billion in 1982 and are expected to rise to $9 billion in 1983.

Foreign aid programs are intended to advance a wide range of U.S. interests. Since the early 1970s, when the "Basic Human Needs" approach was adopted, bilateral economic aid programs have focused primarily on improving the lot of the poorest segment of the population in those nations receiving assistance. Multilateral programs have historically focused on building the foundations of developing economies, including such basic needs as road systems, electrification, and irrigation. More recently, increasing proportions of the resources of the multilateral institutions have been devoted to maintaining levels of development already attained. The World Bank, for example, has provided increasing proportions of its loans for balance-of-payment support to nations encountering financial crises.

Because aid programs advance a wide range of foreign policy objectives, major reductions in aid should be made in the context of a thorough reassessment of those objectives. The Congress could, however, reduce outlays for foreign aid somewhat by altering current programs to adjust to changing international political and economic conditions. As market interest rates rise, for example, the subsidy inherent in reduced-interest foreign aid loans increases. Substantial savings could be realized by making appropriate adjustments in interest charges on these loans. Similarly, aid policies could be altered in accordance with the changing income positions of recipient governments. As economic development progresses, for example, foreign assistance could be made less concessional--that is, less reliance might be placed on outright grants or heavily subsidized loans. Moreover, as nations develop, their access to commercial capital markets should diminish the overall need for concessional assistance. Establishing a link between levels of development and the availability of aid could thus create additional opportunities for budget savings. Specific options are discussed below and summarized in Table VII-9.

TABLE VII-9. BUDGET SAVINGS FROM REDUCTIONS IN AID TO FOREIGN GOVERNMENTS AND INTERNATIONAL ORGANIZATIONS (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Increase the Share of Bilateral Aid Provided as Loans a/						
Budget Authority	4	12	21	33	46	115
Outlays	4	12	21	33	46	115
Raise Interest Rates on Bilateral Loans a/						
Budget Authority	7	23	48	81	123	282
Outlays	7	23	48	81	123	282
Decrease Paid-In Contributions to Multilateral Development Banks						
Budget Authority	31	31	31	31	97	219
Outlays	4	11	15	19	43	92

a. Savings from this pair of options are not additive.

Increase the Share of Bilateral Aid Provided as Loans and Raise Interest Rates. In recent years, an increasing proportion of U.S. assistance authorized under the Foreign Assistance Act of 1961 has been provided in the form of grants rather than loans. While 29 percent of bilateral assistance in 1980 was provided in the form of loans, by 1982 that share was only 15 percent. This trend has occurred across all forms of bilateral economic assistance and security assistance programs.

Significant savings could be achieved by increasing the share of bilateral assistance provided in the form of concessional loans rather than grants. Increasing loans to the same proportion as prevailed in 1980 could result in increased repayments--in effect savings--of $115 million through 1988. Other savings could be obtained by setting interest rates on the loans closer to those prevailing among commercial lenders. The Foreign Assistance Act fixes minimum interest rates on bilateral loans at 2 percent during program implementation and 3 percent during repayment. If the rates were set at 8 percent, repayments would increase by $282 million over the next five years.

Decrease Paid-in Contributions to Multilateral Development Banks. The United States participates in several multilateral development institutions, including various facilities of the World Bank and the Asian and Inter-American Development Banks. These institutions in turn make funds available to developing countries at concessional rates of interest. Unlike bilateral development assistance, which has focused on the basic needs of the poorest peoples in developing countries, multilateral assistance has focused on the development of infrastructure--such as road construction, energy exploration and development, and electrification.

The United States has historically provided the bulk of the financing for these organizations, contributing 25 to 30 percent of their total resources. These contributions can be separated into two components: "paid-in" and "callable" capital. Paid-in capital consists of funds authorized and appropriated by the Congress that are actually disbursed to the lending institutions. These funds are used to make loans to the poorest developing nations at well below market rates of interest. Callable capital, by contrast, is only subject to authorization by the Congress and, in fact, is never disbursed from the U.S. Treasury. Callable capital--along with similar contributions on the part of other donor countries--provide guarantees for the financial instruments that development banks issue in order to raise funds in world financial markets. The proceeds from these bond sales are then lent to middle-income countries at rates that reflect the cost of funds to the lending institution. An actual drawing by the development banks on such callable capital would occur only if the institution was unable to meet its obligations to its creditors.

Historically, about 10 percent of the funds authorized for multilateral development banks have been in the form of paid-in capital. In recent years, as more of the nations eligible for loans have attained higher levels of development (allowing for lower levels of concessionality), the ratio of paid-in capital has declined to 7.5 percent of total contributions. As the poorer countries that borrow from these institutions develop economically, this ratio could be further reduced. If paid-in capital was reduced to 5 percent of total contributions by 1988, savings through that year would amount to $92 million.

Other Government Operations

The final category of nondefense discretionary spending--"other government operations"--totaled $17 billion in 1982 and is expected to rise to $19 billion in 1983. Although these costs cover many different activities, ranging from the conduct of foreign affairs to the regulation of occupational health and safety, three areas account for about 70 percent of total expenditures--the administration of Social Security and Medicare, the administration of justice, and the collection of taxes and other general management functions.

Because the great majority of all expenditures in this category are attributable to the costs of paying federal employees, significant savings would require workforce reductions. [6] Relatively uncontrollable workload factors limit the savings opportunities, however. As the number of Social Security beneficiaries increases, for example, more resources are needed to administer that program and process claims. Similarly, as the number of income-tax filings grows, the size of the Internal Revenue Service expands. Savings opportunities are further limited by recent policy decisions to expand activities for drug enforcement, control of violent and white-collar crime, income tax compliance and simplification, and the collection of debts owed the government. Any workforce reductions that could be achieved would eventually produce annual payroll savings of approximately $250 million in 1984 dollars for each reduction of 10,000 federal employees. In the short run, however, workforce reductions could increase outlays as a result of severance payments, payments for unused leave, and retirement refunds for laid-off federal workers.

Other savings--described below and summarized in Table VII-10--could be achieved either by cutting administrative overhead or by changing the way in which legislative mandates are applied.

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6. Options for reducing outlays through changes in compensation rules and pension benefits are discussed in Chapter VIII.

TABLE VII-10. BUDGET SAVINGS FROM REDUCTIONS IN OTHER GOVERNMENT OPERATIONS (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Improve Federal Office Space Use						
Budget Authority	10	50	95	140	190	485
Outlays	10	50	95	140	190	485
Change Davis-Bacon Wage Requirement a/						
Budget Authority	95	100	105	110	115	530
Outlays	30	60	80	90	100	365

a. Some of these savings would appear in national defense budget accounts.

Improve Federal Office Space Use. The General Services Administration (GSA) acquires and manages some 146 million square feet of office space for federal agencies. About half of the GSA inventory is government-owned space and the other half is obtained through commercial leases. Since 1975, GSA has assessed agencies for the use of office space through charges that are intended to approximate rents for comparable space in the private sector.

Costs could be reduced by utilizing the existing office space inventory more efficiently. In the past, GSA targeted a 20 percent reduction in office space for executive branch employees, but has now lowered its target to about 7 percent. If a 10 percent reduction could be phased in over the next five years, savings of $485 million could be achieved through 1988, with annual savings exceeding $235 million thereafter. Such a change could, however, cramp some agency operations and might require expanding GSA's authority to assign office space. (The savings shown here reflect both reduced outlays from scaling back the leased inventory of privately owned offices and the increased offsetting receipts from leasing some of the unused government-owned space to nonfederal tenants.)

Change Davis-Bacon Wage Requirement. The 1931 Davis-Bacon Act and over 70 related federal statutes require that wages paid on most federally funded and federally assisted construction equal the prevailing wage in the local area. The prevailing wage is now determined by the Secretary of Labor to be that rate paid to a majority of workers in each job classification. If there is no majority paid at an identical rate, the rate paid to at least 30 percent of workers is used; finally, if there is no identical wage paid to at least 30 percent of all workers in a job classification, the average wage for the classification is used. In 1981, these requirements covered about two-fifths of the $237 billion in new construction put in place in the United States.

Recent evidence suggests that in some localities and for some types of construction the 30 percent rule raises federal construction costs by favoring union wage scales rather than the local prevailing rate. In January 1982, the Department of Labor issued a regulation that will eliminate the 30 percent rule, leaving the majority or average wage rules in effect. This change is expected to result in cumulative outlay savings of nearly $500 million through 1988. Additional savings could be achieved if the Congress amended the Davis-Bacon Act to define the prevailing wage as the average local wage rate--eliminating the majority rule entirely. Such a change would reduce outlays by $365 million through 1988--in addition to the savings expected to be achieved by the new regulations. This change would, however, alter the longstanding interpretation of the prevailing wage as the rate paid to most workers in an area, moving instead to a wage standard--the average--that may actually not be paid to any present workers. Moreover, this change would actually increase the wage standard for those labor markets in which the average rate exceeds the majority wage.

CONCLUDING COMMENTS

Nondefense discretionary spending is expected to total $145 billion in 1983--up only $4 billion since 1980. Over that three-year period, spending for this budget category will decline by 16 percent in real terms and decrease from 24 percent to 18 percent of all federal outlays.

Although nondefense discretionary spending has grown very little during the past three years, while shrinking in real terms and as a share of all federal outlays, the Congress might choose to reduce funding for specified appropriated domestic programs as a partial solution to looming budget deficits. Because of the fragmented nature of nondefense discretionary spending, however, appreciable overall savings could be achieved for the category as a whole only by combining cuts in numerous individual programs. Identifying opportunities for such further reductions in an area of the budget that has already been subjected to substantial funding cutbacks is the challenge facing the Congress in dealing with nondefense discretionary spending in the 1984 budget.

CHAPTER VIII. COMPENSATION FOR FEDERAL CIVILIAN WORKERS

In 1982, more than $1 of every $10 the federal government spent--a total of $77 billion, or 10.6 percent of the federal budget--went toward the pay and benefits of federal civilian workers. Of these total compensation expenditures, 91 percent went to pay 2.2 million active-service employees and to disburse pensions for 1.8 million annuitants. The remaining 9 percent covered the costs of other employee benefits--group health plans, life insurance, workers' compensation, and the like. About two-fifths of these compensation costs supported activities in the Defense and State Departments; the remainder supported domestic activities carried out by other agencies.

Costs for the various components of civil service pay and benefits affect different portions of the federal budget, and they are distributed among the accounts of the relevant agencies. To present a unified view of federal civilian personnel costs, and to illustrate various possibilities for achieving budgetary reductions in this area, this chapter combines the various aspects of compensation. The deficit reduction options examined would either change levels of pay and benefits or limit the numbers of persons receiving such payments. (Because changes in numbers of employees influence pay and benefit outlays, compensation-related budgetary savings could result from some of the program reductions considered in Chapter VII, inasmuch as those reductions could affect numbers of federal civilian personnel.)

BUDGET HISTORY AND PROJECTIONS

Since 1980, the cost of compensating federal employees has grown at an average annual rate of 9.8 percent. Recently enacted legislation that effected program cuts has moderated compensation expenditures, however, and will continue to do so in the future. Even so, total 1983 costs for federal civilian pay and benefits will exceed $82 billion--some $5.6 billion more than in the year before. The net budgetary impact is somewhat smaller, estimated at $72 billion for 1983, because of receipts and collections from off-budget agency contributions and from employee withholdings for Civil Service Retirement (CSR) and other benefit programs. (The U.S. Postal Service, an off-budget federal entity, participates in the same fringe benefit programs as on-budget agencies. Thus, this chapter includes fringe benefit expenditures for postal workers and retirees but excludes postal payroll costs.)

Recent History, 1980-1982

Expenditures for pay alone account for more than 65 percent of annual compensation costs. From 1980 through 1982, however, nearly one-half of the $13 billion cost increase occurred in federal benefit programs--$4.8 billion in federal pensions and $1.7 billion in other benefit costs (see Table VIII-1). Over 60 percent of the $6.5 billion increase in federal benefit costs resulted from post-retirement increases in CSR annuities automatically linked (that is, indexed) to changes in the Consumer Price Index. Higher health-care premiums and more numerous CSR beneficiaries caused most of the remaining growth.

The rapid rise in federal compensation costs was tempered by limits on annual pay increases, which held federal salaries below private-sector levels. To a lesser extent, cost growth was also moderated by legislative changes that tightened disability requirements for federal employees, substituted annual adjustments for semiannual increases in CSR benefits, and prorated the initial adjustments received by new annuitants to reflect more accurately price increases since individual retirement dates. The growth in compensation costs was also checked by reductions in the number of federal civil servants. (In the 1980-1982 period, a cutback of some 168,000 Executive Branch jobs was offset by Defense Department hiring of some 49,000 more civilians.) Without these moderating factors, some $6 billion would have been added to federal payroll costs in 1982 and about $1 billion (on an annualized basis) to payments for federal pensions.

The Current Situation

For 1983, the Congress has cut compensation outlays by some $2.0 billion by reducing various features. About 92 percent of that savings derived from the decision to continue the past practice of restraining the size of annual federal pay raises. The Congress halved the 8 percent annual pay adjustment (CBO's estimated annual rise in private-sector pay as incorporated in the baseline developed last year for 1983) to 4 percent for most government workers. By comparison, the Office of Personnel Management estimated that an average adjustment of 18.5 percent (ranging from 15 to 31 percent) would have been required in 1983 to make federal white-collar salaries comparable with those currently paid for similar private-sector work. (In a related action, the Office of Management and Budget required federal agencies to absorb about half of the costs resulting from both the 4

TABLE VIII-1. BUDGETARY OUTLAYS AND RECEIPTS FOR FEDERAL CIVILIAN COMPENSATION (In billions of dollars)

	Actual		Estimated	Baseline Projection				
Major Program	1980	1982	1983	1984	1985	1986	1987	1988
				Gross Outlays				
Pay	44.4	51.0	53.2	56.1	59.0	61.9	64.9	68.1
Civil Service Retirement	14.7	19.5	21.2	22.8	24.4	26.4	28.3	30.2
Other Benefits a/	4.9	6.6	8.3	10.1	12.1	14.3	17.0	20.2
Total	64.0	77.1	82.7	89.0	95.5	102.6	110.2	118.5
				Receipts and Collections				
Civil Service Retirement	5.2	5.8	6.0	6.2	7.0	7.5	7.7	8.0
Other Benefits a/	2.4	3.6	4.4	5.4	6.4	7.6	9.0	10.7
Total Offsets b/	7.6	9.4	10.4	11.6	13.4	15.1	16.7	18.7
				Net Budget Impact				
Total	56.4	67.7	72.3	77.4	82.1	87.5	93.5	99.8

a. Includes group health plans, life insurance, and workers' compensation.

b. Includes contributions from federal employees and off-budget agencies, which represent federal revenues and offsetting receipts, respectively.

percent pay adjustment and the imposition of the 1.3 percent Medicare tax that began January 1983. These absorption requirements may cause a slowdown in hiring of new employees and cuts in nonpay items such as travel.)

The remaining 8 percent of 1983 compensation savings, totaling $0.15 billion, resulted from numerous measures contained in the Reconciliation Act of 1982. Under that act, the Congress temporarily reduced three features of compensation: the pay of military retirees employed by the government as civilians (so-called "double dippers"), the frequency of cost-of-living adjustments (COLAs) for all federal retirees, and the size of COLAs received by retirees under age 62. [1] These reductions are to be effective through 1985. The act also specifies permanent changes that modify restrictions on counting post-1956 military service toward federal civilian retirement benefits, and required administrative changes in the calculation or timing of certain pay and benefits received. These changes are projected to have relatively small effects in 1983, but taken together, they help control costs in future years.

Baseline Projections, 1984-1988

During the 1984-1988 period, combined federal outlays for civilian pay and benefits are projected to grow from $89 billion to $118 billion. This represents an average annual increase of 5 percent in payroll costs, and 11 percent in benefit costs. (The CBO assumes annual inflation rates over the same period to average about 4 percent.)

The five-year projections for federal civilian payroll costs assume no further employment reductions in the nondefense agencies beyond those already scheduled through 1983. They do, however, reflect the 3 percent growth in Defense Department civilian employment projected by the Administration for the 1984-1988 period. In addition, annual pay raises included in the CBO baseline assume that federal wages rise at the same rate as those going to comparable private-sector employees. Those rates exceed--by about 1.1 percentage points per year--the 4 percent pay increases targeted for 1984 and 1985 by the 1983 budget resolution, and exclude the 14 percent

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[1] The Reconciliation Act of 1982 lengthens the interval between COLAs to 13 months for 1983, 1984, and 1985. During this time, civil service retirees younger than age 62 will also receive smaller increases than older CSR annuitants, unless the annual rate of inflation (as measured by the CPI) falls below 3.6 percent. The COLAs for younger CSR retirees are guaranteed at least to equal 3.3 percent, 3.6 percent, and 3.3 percent, respectively, through 1985, but not to exceed the annual change in the CPI less the rate guaranteed for each period. Other changes required by the 1982 act in administering federal compensation include increasing the number of scheduled work hours per year (from 2,080 to 2,087) used to calculate salaries for most white-collar federal employees, rounding down retirement benefits to the nearest lower dollar, eliminating pension payments for partial months attributable to date of retirement, and tightening eligibility provisions for disability and early retirement.

"catch-up" to close the gap between federal and private-sector pay that has resulted from prior-year limits. 2/

Higher federal benefit costs result mainly from outlay increases in two areas--Civil Service Retirement and health insurance (the Federal Employees Health Benefit, or FEHB, program). 3/ Together, these programs are projected to grow from $31 billion to $47 billion--a 53 percent increase--with about five-ninths of the growth resulting from higher health-care costs. Expiration of temporary measures enacted to limit COLAs for federal retirees is also reflected in CBO projections.

DEFICIT REDUCTION STRATEGIES

Two fundamental paths are available to the Congress for limiting federal compensation costs: to lower the number of recipients of federally funded pay and employment benefits, and to restrict the size of such payments. One obvious way to curb the projected growth in federal compensation costs would be to freeze civilian pay and benefits at 1983 levels. A one-year moratorium on annual civilian pay increases and pension adjustments, for example, would reduce 1984 outlays by some $2.9 billion. Less severe options that also affect federal compensation levels range from adopting practices more typical of private-sector employers to enacting narrowly targeted federal pay and benefit modifications.

In addition, the Congress could also increase the government's reliance on the private sector for providing services of a commercial nature. 4/ This chapter identifies the potential budgetary effects of accelerating the government's use of certain contractor-provided services. It also examines one aspect of recovering costs by charging users of federally supplied

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2. In light of past practices for restraining federal pay increases, it does not appear realistic for baseline projections to assume implementation of pay comparability, as currently measured by the Office of Personnel Management under the Pay Comparability Act of 1970. The Office of Personnel Management believes the pay comparison process needs reform and could submit new proposals this year.

3. For further analysis of these programs, see Congressional Budget Office, Civil Service Retirement: Financing and Costs (May 1981) and Reducing the Reserves of the Federal Employees Health Benefit Program (June 1981).

4. For further analysis, see Congressional Budget Office, Contracting Out for Federal Support Services: Potential Savings and Budgetary Savings (October 1982).

services--namely, by eliminating certain indirect cost subsidies enjoyed by customers of the U.S. Postal Service. (Chapter IX examines numerous other applications of the user-charge principle.)

REDUCING FEDERAL PAY

If the main objective of 1984 budget strategies is to achieve immediate savings that will increase over time, several pay reduction possibilities are available. The courses identified in this section entail no reduction in the level of federal programs or services, although decreases in service quality might eventually result. Adoption of any of the alternatives would avoid substantial budgetary costs over the next five years--outlay savings estimated to range between $6 billion and $20 billion (see Table VIII-2). The approaches described in this section can be viewed as practical--albeit austere--public policy responses to persistent requirements for federal budgetary constraint. All would set aside the legislative goal of making federal pay comparable with that in the private sector, however, because achieving salary comparability, as it is measured under current law, would be so costly.

Opponents of such measures would argue that the proposals have little in common with compensation practices considered typical of the nonfederal sector and, if adopted, would undermine the role of the government as a model employer. They would claim that recently enacted limits on the size of annual pay increases, as well as on the timing and amount of post-retirement COLAs, should more than satisfy the government's need to reduce federal compensation costs.

Delay Within-Grade Pay Increases

Most blue-collar and white-collar federal employees (except managers and supervisors) are eligible for periodic pay increases based essentially on length of service. The waiting period for these so-called "within-grade" increases ranges from a minimum of one year to a maximum of three years, depending on time served in a position at a particular grade. 5/ If the

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5. The majority of federal white-collar employees are covered by Grades 1 through 15 of the General Schedule, which consists of 10 steps per grade. The statutory pay system for most blue-collar employees, the Federal Wage System, consists of 15 grades with 5 steps each. Longevity step increases only affect pay rates, and do not imply changes in an individual's job responsibilities.

TABLE VIII-2. BUDGET SAVINGS FROM STRATEGIES TO REDUCE PAY AND PENSIONS FOR FEDERAL CIVILIAN EMPLOYEES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Delay Within-Grade Pay Increases						
Budget Authority	0.3	0.6	1.1	1.8	2.5	6.3
Outlays	0.3	0.6	1.1	1.8	2.5	6.3
Index Pay to CPI Changes						
Budget Authority	0.7	0.9	1.1	1.5	2.1	6.2
Outlays	0.7	0.9	1.1	1.5	2.1	6.3
Freeze 1984 Pay and Pension Adjustments						
Budget Authority	2.6	3.4	3.6	3.6	3.8	17.1
Outlays	2.9	4.0	4.2	4.4	4.6	20.0
Modify CSR Benefits						
Budget Authority	--	0.2	0.4	0.5	0.7	1.7
Outlays	0.2	0.6	1.2	1.7	2.3	5.9
Revamp CSR System						
Budget Authority	-0.1	-0.3	-0.5	-0.7	-0.9	-2.5
Outlays	--	0.1	0.2	0.3	0.3	0.9
Adjust Certain CSR Annuities for Past Overcompensation						
Budget Authority	--	0.1	0.2	0.3	0.4	1.0
Outlays	0.1	0.2	0.5	0.8	1.0	2.6

NOTE: Totals may not add because of rounding.

waiting periods were extended for all employees by six months, five-year savings would total $6.3 billion.

Prolonging the intervals between within-grade pay raises is a plausible and less disruptive alternative to civilian employment reductions, which have been carried out in many federal agencies. Further, it might offer an incentive for federal workers to improve performance so as to increase eligibility for pay increases gained through promotions or cash awards. The opposite view is that any change in the rules governing within-grade raises would violate the terms of federal employment and would depress employee morale. Because of the effective reduction in wages, the federal service theoretically would attract and retain less qualified personnel, though analytically measuring the effects of such changes would be difficult.

Index Pay Adjustments to CPI Changes

Under current policy, the annual October pay adjustments recommended for federal white-collar employees are designed to keep federal salaries equivalent to those paid in the private sector for similar work. Since 1970, however, six adjustments below comparability have been approved under current provisions of law, and the Congress recently established a budgetary target whereby annual pay increases would not exceed 4.0 percent through 1985. If, for the next five years, the Congress set aside the pay comparability authorization by tying government-wide adjustments to changes in inflation (as measured by the CPI) only, annual pay raises would average 4.3 percent--about 0.7 percentage points below the average change in private-sector rates.

Tying federal civilian pay adjustments to the annual change in the CPI would provide an interim rationale for determining their size and give the Congress time to evaluate other pay reform approaches. Relative to the CBO baseline, CPI indexation could save $6.3 billion over the 1984-1988 projection period. (The CBO baseline assumes annual federal pay increases to equate to adjustments projected through 1988 for nonfederal workers.) Moreover, when combined with within-grade increases and promotions for career advancement, the pay of many federal workers would exceed CPI increases and thus grow in purchasing power.

Long-term use of such indexation in place of the pay comparability standard, which looks to private-sector salary levels as the norm, could be viewed by many critics as a significant dilution of the equal-pay-for-equal-work doctrine. Such action could ultimately lead to recruitment and retention problems that adversely affect the delivery of federal services. Continued federal layoffs and high national unemployment, however, would probably limit or delay such effects.

Freeze 1984 Pay and Retirement Adjustments

Current law provides for annual adjustments both in federal employees' pay and in CSR annuities. Together, these adjustments account for most of the last decade's growth in federal compensation costs. For civilian white-collar employees, pay adjustments occur each October on a nationwide basis; for blue-collar workers, annual adjustments occur at different times of the year on a local area basis. Cost-of-living adjustments for CSR annuitants are generally granted each March, although the 1982 Reconciliation Act delays adjustments by one, two, and three months, respectively, for each of the next three years. If, in 1984, a government-wide freeze on civilian pay and retirement adjustments were enacted for one year, savings through 1988 would accumulate to $20 billion--$16 billion from pay and $4 billion from retirement.

Advocates of these measures would point not only to potential budgetary saving, but also to examples in earlier periods and the private sector. Skipping the 1984 adjustments both in active-service pay and in annuities would follow precedents set in the 1950s and early 1960s. During that period, pay and post-retirement increases were provided on an irregular, ad hoc schedule--on average, once every 24 months. Moreover, because of economic conditions, pay freezes have recently become a subject in an increasing number of private-sector labor negotiations, and they may be considered by several state governments as well. 6/

Critics would view the wage-freeze proposal as unfair, because it would apply only to a small segment of the nation's labor force--one whose liberal and nontransferable retirement benefits, in particular, discourage job mobility. Opponents of a freeze would also point out that federal pay adjustments have failed to keep pace not only with the cost of living (as measured by the CPI), but also with compensation practices in the private sector--in theory, at least, the benchmark against which federal compensation is measured. (To counter this argument, of course, observers might note that private-sector pay, too, has lagged behind the cost of living, and that unemployment in the private sector stands at a record high level.) In addition, a pay freeze could prompt experienced federal employees and top managers to retire early (a practice that itself has federal costs) and possibly create recruitment and retention problems.

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6. It is difficult to determine the net reduction that selective pay freezes would have on the overall increase in private-sector salaries. To the extent that reductions occurred, potential savings from a federal wage freeze, relative to the CBO baseline, would decline.

REDUCING FEDERAL PENSION COSTS

Federal employees contribute more toward their retirement program than do their private-sector counterparts who are covered not only by an employer-provided annuity plan but also by Social Security. A portion of private-sector retirement income--mainly, the Social Security share--is now tax-free, whereas CRS pensions are fully taxed after a retiree's benefit payments exceed the contributions he made during his career as an active worker. Even taking into account differences in contributions (private-sector workers rarely contribute to their pension plans) and tax status, however, CSR annuitants still receive more generous benefits.[7] From this point of view, the government's retirement costs are higher than the typical private-sector employer's.

The level of an annuitant's CSR benefit is based on his years of federal service and on the three years of his highest earnings. In light of the relationship between salary levels and annuities, and the fact that pay and benefit cuts enacted since 1980 are unlikely to be reversed, large reductions in prospective federal pension costs will require more fundamental policy decisions. Some of these decisions have been postponed because of modest short-term effects or because equivalent budgetary savings could be achieved through less complicated or far-reaching measures.

Better alignment of federal retirement costs with private-sector retirement could be achieved by changing the CSR program either in conjunction with extending Social Security coverage to federal employees (addressed in Chapter III), or by applying an independent measure that would establish CSR as a substitute for the two-part retirement income generally available in the private sector. Two of the options described below follow this latter strategy. One would modify selected benefit provisions; the other would completely reconstruct the system. (Of course, the net budgetary impact of federal retirement costs could also be reduced by increasing employee or off-budget agency contributions. However, increasing employees' payroll withholdings--these are generally set at 7 percent of pay and matched by employing-agency contributions--would not align the federal system with the private sector, in which employee contributions are generally limited to Social Security withholding taxes plus a portion of premium costs for long-term disability insurance. Increasing contributions from off-budget agencies is described later in this chapter.) The last strategy, reducing future COLAs for certain CSR recipients, would adjust federal pensions for what is held to be past "overcompensation." All the alternative strategies would depart from recent federal policy, which kept retirement costs relatively high while limiting the size of annual active-service pay adjustments.

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[7] If the tax advantage now available to Social Security annuitants were reduced--by the enacting of either the recent recommendations of the National Commission on Social Security Reform or a similar proposal--the relative advantages of CSR benefits would rise accordingly.

Modify Civil Service Retirement Benefits

Compared with retirement payments typical of the two-part system available to private-sector workers, benefits under CSR are large. If the Congress patterned CSR benefit provisions after typical private-sector practice, federal costs would decline. Such a modified CSR benefit structure could include the following actions:

- Gradually reduce earned benefits for federal workers who retire before age 65, regardless of their length of service. At present, CSR benefits are available without reduction either at age 55 after 30 years of service or at age 60 after 20 years of service. The 1988 savings would be $0.1 billion.
- Calculate benefits based on the employee's average salary for the five years of highest earnings--rather than the three-year average currently used. The 1988 savings would be $0.3 billion.
- Base annuity reductions for survivor benefits on actuarial factors, which would vary by the age of the retiree and of the spouse. Under the present system, reductions equal a fixed percentage of the earned annuity regardless of age differentials. The 1988 savings would be $0.2 billion.
- Limit COLAs to 33 percent of changes in the CPI for retirees under age 62 and to 70 percent for those aged 62 and older. This would achieve a blend of average adjustments provided by Social Security, which is indexed to the full amount of the change in the CPI, and the ad hoc increases available under some private pension plans. The 1988 savings would be $1.6 billion.

Except for limiting COLAs, these modifications in CSR benefits would apply to new retirees only and thus would yield relatively small savings in the first five years. In the long run, however, savings from non-COLA changes would grow, as more and more individuals joined the retirement rolls. In the area of COLAs, the changes would apply to new and current annuitants alike, and thus they would generate savings in the near term--beginning at $0.1 billion in 1984 and reaching $1.6 billion in 1988. A less severe limit could be considered by simply extending--beyond 1985--a measure similar to the temporary COLA limit now in effect on the amounts received by younger retirees. But if future adjustments for CSR retirees younger than age 62 were set at 70 percent of the CPI, for example, outlay savings in 1988 would barely reach $0.1 billion.

Support for modifying CSR benefits would rest on the belief that federal costs, which are ultimately paid by the taxpayer, should hold to the standard that would prevail if the government adopted practices more typical of the private sector. The contrary view holds that existing CSR benefits are fair recompense for pay limits effective during active federal employment, and that employees--especially those near retirement--would be unfairly hurt by unanticipated changes in the rules determining their pension benefits. This latter objection could be met by a gradual phase-in of the changes.

Revamp Civil Service Retirement

As an alternative to modifying particular benefit provisions, the Congress could establish individual retirement accounts for new employees. Under current practice, agency and employee contributions are pooled, and together, they partially fund the annuities of former employees who have already retired and whose benefits greatly exceed amounts contributed on their behalf. Funds for the remaining benefit costs require annual appropriations from the U.S. Treasury. Instead, projected benefit payments could be prevented from exceeding amounts contributed by employees and agencies into the individual earmarked accounts, as augmented by interest earnings.

Many different fixed-rate plans are possible, varying according to provisions covering contribution levels, investment of funds, participation of current employees, and circumstances under which benefits can be drawn. 8/ A fixed-rate plan could be financed in the following manner.

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8. The fixed-rate plan described here differs from that contained in S. 2905, introduced in the Senate in September 1982. If enacted, that bill would also provide Social Security coverage, an optional thrift plan, and a fixed-rate plan for new federal workers. In addition, the bill would eventually allow investments in financial instruments other than U.S. Treasury securities, which would cause federal outlays to rise and could require significant resources to administer. Finally, S. 2905 would also allow participation by current employees.

Employee contributions could remain at the current withholding rate of 7 percent of pay; employing agency contributions would be raised to 21.5 percent, at which level they would equate to the combined actuarial value of Social Security (less projected employee contributions) plus a typical employer-provided pension plan. Total contributions would thus come to 28.5 percent. The value of such benefits would roughly equal four-fifths of those now available, largely because of the loss of guaranteed COLAs. (Such adjustments are expensive under any economic conditions. But because of the double-digit inflation rates recently experienced--double or triple the long-term projections actuaries use--the cost impact of COLAs has been particularly dramatic.)

Under a fixed-rate plan, the true cost of federal pensions would equal agency contributions and, as the annual appropriations necessary to fund current benefits gradually disappeared, long-term savings would begin to result. In the near term, however, neither appropriations nor outlays for CSR benefit payments would be appreciably affected, because the plan would apply to new employees only. But higher contributions from off-budget agencies, primarily the Postal Service, would result in outlay reductions of $0.9 billion through 1988. Finally, given growing concern over near-term outlay increases, the plan could avoid budgetary expenditures by limiting its investments to special U.S. Treasury issues (securities), and by making the government's contribution available in full only to workers who stay in the system for a specified term--for example, five or ten years.

If the Congress were to extend Social Security coverage to new federal employees (as described in Chapter III), the government's cost for the portion of benefits from a fixed-rate plan could drop from the 21.5 percent rate cited above to 8.4 percent of salary. This rate reduction would be made up by the federal costs for Social Security, including those associated with the system's current underfunding and the tax-free status of its benefits. Advocates of this plan would find several advantages in it, including the transferability of benefits between public- and private-sector employment, the elimination of the "windfall" payments now available to federal retirees after relatively few years of Social Security participation, and, of course, the curbed federal pension costs.

At present, most employees who leave government service before retirement age elect to withdraw their contributions rather than receive the deferred annuity to which they are entitled upon turning 62. A fixed-rate pension plan would allow intermittent and short-term federal employees the opportunity to accrue continued investment earnings on their contributions--either to take advantage of the tax-deferred feature of the plan's dividends, or in anticipation of eventually securing entitlement to the government's contribution and associated investment earnings. As a result, the percentage of workers who eventually receive a federal annuity would increase. On the other hand, benefits for career employees would drop substantially because the government's costs (employer contributions and Treasury appropriations) would decline as a percent of payroll, while the number of recipients would increase. In addition, major administrative hurdles would undoubtedly arise in implementing a fixed-rate plan.

Adjust Certain CSR Annuities for Past Overcompensation

Statutory provisions governing COLAs under CSR during the 1970-1976 period caused each adjustment to reflect the full change in the CPI plus one additional percentage point. Although the Congress withdrew the add-on in 1976, it did not make the rescission retroactive. Thus, the add-on continues to affect the size of current benefits of pre-1977 retirees and has led to what some observers consider overcompensation. Another type of overcompensation has also resulted, especially in recent years, because retirement COLAs have often exceeded annual pay adjustments. In combination, these factors have caused the retirement pay of many federal annuitants who retired between 1970 and 1976 to be higher than that of workers who retire today at similar grade levels and with comparable periods of government service. This overcompensation could be corrected by temporarily restricting future COLAs for affected CSR annuitants to half the CPI change. The duration of the restriction would depend upon the difference between the COLAs received and the size of federal pay raises since the individual's date of retirement. Such action would yield annual savings totaling $1.0 billion in 1988.

Proponents of a COLA limit would argue that cuts affecting retirees who benefited from the pre-1977 overindexation would be appropriate--especially in times of budgetary stringency--and fair. They would also note that the CPI has overstated rises in the cost of living, especially in recent years, and benefit increases linked to that indicator have tended to be excessive. The flaw in the CPI, pertaining to the weight given to shelter costs, has been corrected prospectively--by a change to be effective in 1985; adjustments to correct retroactively for past overindexation have not been proposed. In addition, civil service retirees have enjoyed greater protection against price increases than have their private-sector counterparts and federal employees, whose pay raises have lagged behind the CPI. If this greater protection continues, federal workers--particularly during periods of high inflation--would have stronger incentives to retire as soon as they become eligible, leading to upward pressure on federal retirement costs.

Opponents would argue that the Congress took sufficient action in 1976 to curb the overindexation of federal retirement benefits. After so many years, to require annuitants to forgo extra income by limiting future COLAs would be unfair. In response to the criticism that federal annuities have been rising faster than pay, some observers would hold that the resulting retirement exodus is the price of the government's policy to restrain pay raises for budgetary reasons. The solution, they would contend, is not to reduce retirees' protection against inflation, but rather to set compensation for active employees at levels that can attract and retain the desired work force.

REDUCING EMPLOYMENT COSTS

This section describes two strategies that could reduce federal employment costs without changing federal pay and benefit levels. First, requiring the Postal Service to fund its full share of retirement and annuitant health-care costs could result in 1988 savings in excess of $1.5 billion. (Elimination of other subsidies to the Postal Service is examined in Chapter IX.) The second strategy--making more vigorous use of private contractors to meet the federal government's needs for certain support services--could reduce the total federal work force and thus lower compensation costs in the long run.

Charge the Postal Service for Annuitant Health Care and Retirement Costs

A 1970 reorganization enacted by the Congress converted the Post Office Department, a federal executive department, into the off-budget enterprise now called the United States Postal Service (USPS). 9/ Like most other federal operations, postal employees and the service itself each contribute to the CSR and the federal health-care programs. The Postal Service also contributes additional amounts to the CSR program to cover future retirement cost increases that result from negotiated USPS pay raises. At present, however, the Postal Service incurs no liability for the expense of annual COLAs for postal retirees, or for annuitants' health-insurance costs. These costs are funded through two separate appropriation accounts in the federal budget; this has held down postal operating expenses and postage rates. If the Postal Service were charged for its share of both CSR outlays attributable to COLAs and the federal cost of annuitant health-care coverage, five-year budgetary savings would total $5.0 billion--$2.6 billion for health benefits and $2.4 billion for retirement (see Table

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9. The Postal Reorganization Act of 1970 (P.L. 91-375) was signed into law on August 12, 1970.

VIII-3). These estimates assume that charges to the Postal Service would begin in 1984 and not include cost increases occurring from 1970 through 1983. Postage rates under this proposal could rise by 3 percent over the next five years, resulting in an estimated 1 cent increase for first-class stamps.

TABLE VIII-3. BUDGET SAVINGS FROM STRATEGIES TO REDUCE FEDERAL EMPLOYMENT COSTS (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Charge Postal Service for FEHB and CSR						
Budget Authority	0.4	0.5	0.6	0.6	0.6	2.8
Outlays	0.5	0.7	1.0	1.3	1.5	5.0
Expand Contracting Out						
Budget Authority	0.1	0.3	0.6	0.9	1.2	3.0
Outlays	--	0.1	0.2	0.3	0.5	1.1

NOTE: Totals may not add because of rounding.

When the Postal Service was established, it was expected to achieve self-sufficiency. Thus, in theory, it should not be subsidized by federal appropriations. From this perspective, today's postal system essentially benefits specific individuals and organizations who should bear the full costs of mail services. Moreover, subsidized postal operations could give the Postal Service an unfair advantage over private-sector competitors.

Benefits in both areas covered postal workers before the reorganization effected in 1970, and the law makes their maintenance mandatory. The act prohibits the Postal Service from negotiating benefit changes in the federal health-care and retirement programs and assures continued participation on the part of postal employees. Thus, the service and its customers might argue that the assessment of full benefit costs to the Postal

Service (which applies to no other federal agency) would be unfair and would intensify pressure on postage rates. Obviously, the Congress could continue part of the subsidy, as a short-term compromise, through annual appropriations to the Postal Service rather than to the pension and health-care accounts. This would make the subsidy more visible and improve the government's cost accounting.

Expand Contracting Out

In 1981, the federal government spent some $32.5 billion on commercial-type support services such as property maintenance, food preparation, and security. About 40 percent of the services performed for agencies is now "contracted out" to private-sector firms, with the remainder provided "in-house" mainly by federal blue-collar workers.

Primarily because of lower expenses for pay and fringe benefits, private contractors can often provide the government with support services at less cost than in-house federal workers can. Current policy requires agencies to shift services to private firms. But at the same time, it exempts nearly three-fifths of these services from consideration for conversion; most exemptions are in the Defense Department and the Veterans Administration. Current exemptions are justified on grounds that they protect military readiness and the well-being of military veterans.

If exemptions for certain Defense Department and Veterans Administration activities were relaxed and contracting out accelerated, the number of additional jobs shifted to private firms in the long run could reach 185,000. On this basis, annual savings beyond the next five years could eventually total $1.2 billion (current dollars). Short-term budget savings, however, would be small--averaging $0.2 billion per year through 1988. Contracting out takes time to implement; certain transition costs for employee layoffs and other expenses occur in the short term; and cost savings for such items as retirement have deferred effects.

Supporters of expanded contracting out claim that the government ought not engage in commercial activities that the private sector can provide. With regard to current exemptions, they point out that, in the past, federal agencies have sucessfully used contractors to support military and health-care activities in a variety of circumstances, including armed conflict. In response, critics point to the decline in service quality that often accompanies contracting out and to the employment concerns of federal workers threatened by loss of jobs to the private sector. They claim, moreover, that contracting out support services makes the government party to the substandard compensation practices of certain private-sector employers. With regard to current exemptions, skeptics argue that, limited successes notwithstanding, no chances should be taken that would impair the nation's security or with the commitment to care for war veterans.

CONCLUDING COMMENTS

Actions that limit federal civilian pay and retirement costs could achieve significant budgetary savings. In determining which particular approach to pursue, the Congress will want to weigh potential short- and long-term budgetary effects against the government's responsibilities as a model employer and its need to attract and retain a qualified work force.

At present, many observers believe that the government can ill afford adjustments necessary to achieve comparability between federal and private-sector earnings for similar work. For example, achieving comparable pay levels, as measured under current law, could require October 1983 adjustments averaging at least 20 percent. The CBO baseline, in contrast, assumes a 5.5 percent adjustment that reflects anticipated increases in private-sector pay. In either case, more stringent limitations could be enacted. Major budgetary options available to the Congress include a one-year freeze on federal pay adjustments, indexing pay to annual changes in the CPI, and delaying within-grade salary adjustments. Such measures would avoid from $6.3 billion to $16.2 billion in total federal expenditures through 1988.

The Congress could also undertake modifications in federal retirement provisions, either in conjunction with or as substitutes for restraining federal pay increases. While limiting COLAs offers an obvious means of generating immediate budgetary saving, certain other benefit modifications could also reduce expenditures and help align federal costs more closely with private-sector practice. Alternatively, the Congress could change the retirement system altogether by establishing individual retirement accounts for new employees. The latter approach could significantly reduce federal pension costs in the long run but would probably generate little outlay savings in the next five years.

Potential for additional large reductions in federal compensation costs is also available in two other areas. If more support services now performed by federal workers were contracted out to private firms, the government would eventually spend at least $1 billion less for annual compensation costs, although near-term savings would be small. This subject remains controversial, however, primarily as it bears on quality of service and potential effects on federal job security. Eliminating pension and health-care subsidies now enjoyed by the Postal Service could generate immediate savings--beginning at about $0.5 billion in 1984 and accumulating to some $5.0 billion through 1988.

CHAPTER IX. USER FEES AND OTHER GOVERNMENT CHARGES

The federal government currently subsidizes many activities that serve finite, clearly identifiable, and often narrow groups of businesses and individuals. Rather than continue to subsidize these activities, the Congress could shift the costs of such programs and services from the general taxpayer to the specific beneficiaries. Doing so would entail levying either higher or altogether new fees and charges for the subsidized services. Such fees or charges would reduce the budget deficit by offsetting federal expenditures. At the same time, they would promote an economically efficient allocation of national resources.

The range of federally provided special services and programs is wide. It encompasses construction, maintenance, and operation of public infrastructure (highways, inland waterways, ports, and other major capital facilities that make up the physical framework of the nation's economy), as well as development and management of natural resources through such activities as Outer Continental Shelf leasing for offshore oil and gas production and the generation of electrical power. The federal government also undertakes various financial, informational, and support services as well as numerous regulatory oversight activities that range from economic and financial regulation to environmental and safety regulation. All these special activities and programs fall under the nondefense discretionary spending category.

Under current policy, the beneficiaries or users of many of these special services and programs pay fees or other charges that partly cover their federal costs. The federal government will collect about $27 billion in such fees and charges during 1983 and $36 billion in 1988. 1/ These collections will offset gross federal expenditures for various nondefense discretionary programs.

Budgetary treatment of current user fees and charges varies: most are classified either as budget receipts or as offsetting receipts. Budget receipts are collections (based on the government's power to tax) entered

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1. These estimates include only those fees and charges classified as budget receipts or offsetting receipts. An additional $5 billion to $10 billion are classified as offsetting collections and credited directly to appropriation or fund accounts.

on the revenue side of the budget. Offsetting receipts, coming from business-type or market-oriented transactions between the government and the public, are subtracted from disbursements to calculate total outlays. A large portion of the collections from current user fees or government charges takes the form of offsetting receipts. Some $15.7 billion in fees and charges during 1983 will be offsetting receipts--mostly from Outer Continental Shelf leasing for offshore oil and gas production. These collections will not be reflected in the revenue totals shown in the budget, but they will be deducted from disbursements in order to calculate total outlays--thereby understating gross federal expenditures. Another $11.2 billion in fee collections (mostly from highway and airway users) are classified as budget receipts. These collections are captured in the budget's revenue totals, and similarly, the federal outlays for programs and services financed by these collections are reflected in the budget totals.

BUDGET HISTORY AND PROJECTIONS

The last several years have seen growing recognition that user fees and other charges for government services reduce the federal budget deficit while also promoting efficient investment. Numerous efforts have therefore been made to increase user fees and similar charges, and significant increases in some user fees or charges have been enacted.

Recent History, 1980-1982

Since 1980, the Congress has considered numerous proposals to raise user fees and other charges for government-provided services and programs. President Reagan's first budget submission called for broader application of the user fee principle, including institution of new or increased fees for Coast Guard services, nuclear waste disposal, deep-draft and inland waterway navigation, and aviation. Despite wide discussion of the various proposals, however, no significant Congressional action was taken on user fees before 1982. Collections from user fees and other government charges grew from about $18 billion in 1980 to $20.5 billion in 1982 (see Table IX-1).

The Current Situation

The second session of the 97th Congress did, however, enact several new or significantly increased user fees and government charges. The budget resolution for 1983 called for large revenue increases, a portion of which was to be raised through user fees--specifically, $900 million in 1983,

TABLE IX-1. FEDERAL COLLECTIONS FOR SPECIAL SERVICES AND PROGRAMS, BY CATEGORY (In billions of dollars)

Category	Actual		Estimated	Baseline Projection				
	1980	1982	1983	1984	1985	1986	1987	1988
Public Infrastructure								
Offsetting Receipts	0.4	0.5	0.5	0.6	0.6	0.6	0.7	0.7
Budget Receipts	8.5	7.1	10.9	14.4	14.9	16.1	16.9	17.5
Subtotal	8.9	7.6	11.4	15.0	15.5	16.7	17.6	18.2
Resource Management								
Offsetting Receipts	8.8	12.5	14.8	14.1	14.9	19.4	17.5	17.4
Budget Receipts	--	--	--	--	--	--	--	--
Subtotal	8.8	12.5	14.8	14.1	14.9	19.4	17.5	17.4
Financial, Informational, and Support Services								
Offsetting Receipts	0.2	0.1	0.3	0.3	0.3	0.2	0.2	0.2
Budget Receipts	--	--	--	--	--	--	--	--
Subtotal	0.2	0.1	0.3	0.3	0.3	0.2	0.2	0.2
Regulatory Oversight								
Offsetting Receipts	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Budget Receipts	--	0.2	0.3	0.3	0.3	0.1	*	*
Subtotal	0.1	0.3	0.4	0.4	0.4	0.2	0.1	0.1
Total Fee Collections								
Offsetting Receipts	9.5	13.2	15.7	15.1	15.9	20.3	18.5	18.4
Budget Receipts	8.5	7.3	11.2	14.7	15.2	16.2	16.9	17.5
Total	18.0	20.5	26.9	29.8	31.1	36.5	35.4	35.9

* Less than $50 million.

NOTE: These estimates exclude offsetting collections credited directly to appropriation or fund accounts.

$1 billion in 1984, and $1.4 billion in 1985. The resolution also called for increased offsetting receipts from user fees.

After passing the budget resolution for 1983, the Congress proceeded to enact aviation user fees (under the Tax Equity and Fiscal Responsibility Act of 1982) that increased revenue collections by an estimated $786 million in 1983, $966 million in 1984, and $1.07 billion in 1985--somewhat below the targets set in the budget resolution. (The revenue effects of TEFRA are examined in Chapter X.) Most of this increase reflected a reimposition of taxes that had expired or been reduced in 1981. Thus, enactment of these aviation user fees partly reflected a continuation of past policies.

The 97th Congress, near the close of the second session, also enacted a substantial increase in highway user taxes under the Highway Revenue Act of 1982. The first such rise since the tax was instituted in 1956, this increase raised the highway fuel tax from 4 cents per gallon to 9 cents per gallon, while simultaneously adjusting other highway use taxes. Similarly, several other proposals for new or increased user fees and government charges were enacted, including increased fees for irrigation water provided by the Bureau of Reclamation and new fees for nuclear waste disposal. Collections from user fees and charges for special services and programs will therefore increase in 1983, totaling about $26.9 billion.

Baseline Projections, 1984-1988

Under current policy, collections from user fees and government charges are projected to total $29.8 billion in 1984, climbing to $35.9 billion by 1988. These levels reflect substantial increases in collections from user fees and other government charges over pre-1983 levels. Most of the projected rise stems from the recently increased highway user fees. Collections from highway users will total about $11.7 billion in 1984--an increase of $3.1 billion, or 36 percent, over the 1983 level--and will continue to increase to $13.4 billion by 1988. Highway user tax receipts alone account for some $1.7 billion of the $6.1 billion increase projected between 1984 and 1988. An additional $1.4 billion of this increase is projected to come from aviation user fees. Most of the remaining increase (about $2.4 billion) results from increased receipts from rents and royalties on the Outer Continental Shelf.

DEFICIT REDUCTION STRATEGIES

Though user fees and other government charges for special services and programs reduce the budget deficit by offsetting federal expenditures, the rationale for user fees and charges extends beyond this goal to considerations of economic efficiency and equity. The federal government provides many facilities and services to individuals and businesses at prices below market rates and often below the government's costs as well. Such subsidies may be appropriate if the overall public benefits of a particular activity are greater than the private benefits. But the public benefits at times may not justify the level of federal subsidy. In such instances, subsidies can result in overuse and inefficient allocation of resources.

The inland waterway transport system, which currently receives large federal subsidies, serves as an example. The costs incurred, or perceived, by inland waterway users are much lower than the real economic cost of that transport mode: users are aware only of the lower, federally subsidized cost. Users respond to this low, subsidized cost by demanding or using more inland waterway transport than they would if the full economic cost of inland waterway transport were charged. (This induced demand, in turn, exerts upward pressure on federal expenditures, as the federal government works to keep pace with the demand for waterway transport facilities.) Moreover, to the extent that federal subsidies reduce the cost of inland waterway transport relative to the costs of other freight transport modes, shippers may be induced to choose waterway transport over other freight transport modes, even though, without federal subsidies, an alternate mode may be the lower-cost one for a particular shipment. Federal subsidies can thereby result in overuse and misallocation of scarce resources.

User fees or charges for special government services reduce federal subsidies and promote efficient government investments by shifting the cost of a given service or program to the users or beneficiaries of that activity. Fees and charges establish an incentive to use the most economic level of government service. Users and other beneficiaries become cognizant of the full economic cost of a given activity and adjust demand accordingly. To the extent that beneficiaries reimburse the government for expenditures made in their behalf, they have an incentive to work with the government to ensure that only cost-effective investments are made. Moreover, user fees and charges lift the financial burden for special services and programs from the general taxpayer and allocate financial responsibility in a more equitable manner--to specific classes of identifiable beneficiaries who have the ability to pay for these services and may not need or warrant federal subsidies.

User fees and other government charges could be increased in order to reduce the federal budget deficit, while simultaneously enhancing economic efficiency and equity through two overall strategies:

- **Set fees and charges to obtain the market value for federal services.** In cases where federal services have counterparts in the private marketplace, market prices could serve as a guide for setting levels of federal fees and charges.

- **Set fees and charges for services to recover the full costs to the government.** In instances in which the private market offers no prototype to look to for price levels--or when the federal government is the uniquely appropriate provider of services--user charges could be set at levels that recover the government's costs.

These two strategies for reducing the federal budget deficit can be applied to a variety of special services and programs. Any attempt to recover either the market value or the federal costs of government programs must, however, balance budgetary and economic efficiency goals against administrative and equity concerns.

Ideally, from the standpoint of economic efficiency, the users or beneficiaries of government services and programs should be charged variable fees (as opposed to uniform fees) that reflect the costs imposed, or value derived, by each individual user or class of users. By limiting the number of situations in which certain users subsidize others (by so-called "cross-subsidies"), such variable fees promote both economic efficiency and equity. For example, the costs to build, operate, and maintain the nation's ports vary widely from one port to another. If uniform user fees were imposed on all port users, then users of heavily used, low-cost ports would cross-subsidize the users of other, higher-cost ports. On the other hand, if fees were designed so that collections at each port paid all the costs of that particular port, each facility would pay its own way and cross-subsidies among ports would be eliminated. Such a system would likely result in very high fees at low-volume, high-cost ports and could possibly force some of these ports to close. The net effect, however, would be to route traffic through the more efficient ports where unit costs are lower. Thus, variable fees could encourage the development of a more efficiently-configured port system.

Such improved efficiency comes at some cost, however--specifically, increased administrative costs. In general, variable fees are more cumbersome to administer than uniform, program-wide fees. A uniform fee avoids the complexity of distinguishing between and accounting for the costs and benefits incurred by different individuals or groups of users. Moreover, a uniform fee that spreads the costs over a broad base may reduce incentives to evade the fee, thereby simplifying enforcement.

Another issue in applying the user fee principle to special services and programs centers on the timing of collections vis-a-vis expenditures. Much of the federal spending for special services and programs takes the form of investment in capital facilities. The extended economic life of these facilities raises a question: When should their capital costs be recovered? One option is to recover the costs of these capital investments on a cash basis--that is, set user fees at a level sufficient to offset outlays at the time of expenditure. This may be desirable if many capital projects are under construction over a period of years, as is the case with the highway program. In such instances, users of one project pay for the construction of another project and it is assumed that the cross-subsidies offset each other in the long run. On the other hand, if government expenditures are recovered on a project-specific basis, there are few practical ways to recoup them on a cash basis. Instead, the federal government's investment must be recovered from user fees exacted over the life of the project. The amount of the user fees required will depend on the number of years over which the initial costs are amortized, as well as on the interest rate applied. Full-cost recovery requires that realistic interest rates be applied--otherwise, the user fees may mask substantial subsidies.

A third issue centers on the dislocations and inequities that can accompany increased user fees and government charges. Federal spending for many programs and services began before user fees for these investments were considered. Economic and equity considerations may constrain efforts to recoup these costs by raising existing fees or instituting new ones. For example, if businesses have made investment decisions on the basis of past government subsidies, the sudden enactment of user fees to negate these subsidies could create substantial economic hardships. Though the government has no legal obligation to ensure citizens against changes in its policies, such situations may be unfair and could place a hardship on certain users. As a practical matter, however, dislocational hardships could be greatly alleviated through several alternatives. One option would be to phase in any new or increased user fees. This was done when user fees for the inland waterways were instituted in 1978. Such a phase-in would give users time to adjust to the higher costs and could minimize the dislocational hardships associated with such fees.

The following sections examine the potential for extending the user fee principle in each of the four categories of federal services and programs outlined at the beginning of this chapter. Most of these options have been considered (and many rejected) by the Congress in past sessions.

INFRASTRUCTURE DEVELOPMENT AND MAINTENANCE

A primary example of a federal service investment that is not amenable to market-based prices is public infrastructure facilities--the roads, waterways, and other facilities that make up the U.S. economy's physical framework. These infrastructure investments cannot be provided efficiently by the private market. They do, however, yield important benefits to specific classes of users who can be identified and charged for the services. Federal intervention is necessary simply to coordinate, rather than subsidize, these infrastructure investments. Since the private market offers no equivalent for these services, however, an appropriate benchmark for user fees in this area would be the government's cost. Fees that recover the government's costs would help to shift the patterns of investment toward a more efficient and economic infrastructure and would reduce the federal budget deficit.

A large portion of federal expenditures for infrastructure development, operation, and maintenance is currently funded through user fees, primarily in the areas of highways and airways. The current user fees do not recover the full government costs, however, and in some programs no user fees at all are now in place. Several program areas where user fees could be increased or applied are examined below.

Highways. The primary infrastructure user charges now in place are those that finance the highway program. Highway user charges comprise a series of excise taxes on gasoline, diesel fuel, tires, trucks, and truck parts. Revenues from these use taxes are, for the most part, earmarked and set aside in the Highway Trust Fund for use only in highway programs. (The major exception is that, starting in 1983, the revenues from 1 cent of the 5-cents-per-gallon tax increase on motor fuel--or about $1.1 billion annually--will be used for public transit capital grants.) The trust fund mechanism is intended to make the federal highway program self-supporting: the highway program is financed by highway users.

Although user charges contribute significantly to the federal effort in highways, not all highway users pay these fees; some users are exempt. Thus, although current highway user fees (including the recent increase in highway user taxes enacted in December 1982) will generate an estimated $11.7 billion for highways in 1984, an additional $680 million will be lost through various highway tax exemptions.

Three major groups of beneficiaries are exempt from part or all of the 9-cents-per-gallon tax on motor fuel: state and local governments; bus operators, including transit bus operators, school bus operators, intercity and other private bus operators; and producers of gasohol. Few economic reasons justify continuing these exemptions, which, in fact, are subsidies. Buses and state and local vehicles cause wear and tear on the nation's roads just as other vehicles do. The subsidy to gasohol producers, justified as contributing to the nation's energy independence, is large--equivalent to 50 cents per gallon of ethanol--and appears excessive given gasohol's modest contribution to the nation's energy self-sufficiency. Eliminating these tax exemptions would promote more efficient allocation of resources while increasing annual receipts to the government by about $680 million.

Furthermore, not all highway programs are currently financed from user fees. Some highway expenditures, many of which are outside the transportation function of the budget (such as funds allocated to the Forest Service, National Park Service, Appalachian Development Commission, Department of Defense, and Bureau of Land Management) are financed from general funds. Though the recent highway tax legislation shifted some of these expenditures to the Highway Trust Fund, some 3 percent (or about

$400 million) of all federal spending for highways in 1984 will be financed from general funds. The user fee principle could be extended by financing all highway expenditures from the Highway Trust Fund. This would reduce general fund expenditures by about $2.0 billion over the next five years, but the reduction would be offset by increased spending from the trust fund. Thus, unless highway taxes were increased to cover the costs now paid from general funds, there would be no reduction in the federal budget deficit.

The federal budget deficit could therefore be reduced by as much as $680 million in 1984 through the elimination of all exemptions from highway use taxes. If user fees were increased to fund (on a cash basis) all highway programs, additional savings could total $400 million. Savings from these two options would total $5.4 billion over the 1984-1988 period (see Table IX-2).

Airports and Airways. The other major infrastructure user charges already in effect are those that finance airports and airways. The Airport and Airways Revenue Act of 1970 established a trust fund to finance federal expenditures for airports and airways. The trust fund is financed by taxes on passenger tickets and by certain other taxes paid by airport and airway users. The authorization for these aviation user taxes expired in 1980, but they were renewed last year (at somewhat higher levels than in the past) under TEFRA.

The use of the Airport and Airways Trust Fund has traditionally been restricted to airport capital improvements and a portion of the airway system's operating costs. Trust fund revenues financed only about 38 percent of the system's operating costs in 1982. Thus, user fees funded only about 41 percent (or $1.2 billion) of all federal expenditures for airway capital and operating costs (which totaled $2.9 billion), despite an uncommitted surplus of about $2.2 billion in the trust fund.

The user fee principle could be extended by financing all airway system operating costs from the trust fund. This would curb the drain on general revenues by about $6.9 billion over the next five years, but the reduction would be offset by increased spending from the trust fund. Thus, there would be no effect on the federal deficit unless aviation user fees were increased to cover the operating costs now paid from general funds.

One option for increasing aviation user fee receipts would be to increase the user fees levied on general aviation--that is, aircraft owned and operated by firms and individuals for their own use. At present, general aviation pays only a small portion--less than one-fifth--of its share of federal aviation expenditures. Commercial air carriers, in contrast, currently pay (through the 8 percent ticket tax and other fees financed by

TABLE IX-2. BUDGET SAVINGS FROM INFRASTRUCTURE USER FEES SET TO RECOVER FULL FEDERAL COSTS
(In billions of dollars)

Services	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Highways	1.08	1.08	1.08	1.08	1.08	5.40
Airways	1.07	1.10	1.13	1.07	1.07	5.44
Inland Waterways	.70	.70	.75	.75	.80	3.70
Deep-Draft Navigation	.50	.50	.50	.50	.55	2.55
Coast Guard Services	1.09	1.12	1.15	1.19	1.22	5.77
Total	4.44	4.50	4.61	4.59	4.72	22.86

travelers) more than their attributable costs. General aviation accounted for an estimated $780 million in system costs during 1982 but paid only about $14 million in user charges.

Throughout the 1970s, general aviation users paid a tax of 7 cents per gallon on gasoline and jet fuel. With the 1980 expiration of aviation user fees, this tax temporarily reverted to 4 cents per gallon on gasoline only. General aviation user taxes were subsequently increased under TEFRA to 12 cents per gallon of gasoline and 14 cents per gallon of jet fuel. Nevertheless, general aviation users still pay only a small portion of their costs. Only if these taxes were increased to about $1.20 per gallon of fuel would general aviation users pay their full costs. Such a fuel tax increase would be neither an efficient nor an equitable means of recovering general aviation costs, however. Fuel consumption does not necessarily reflect the benefits received or costs imposed by individual general aviation users at different airports. Landing fees or congestion tolls would thus be a more efficient and equitable means of generating the same revenues. In either case, full recovery of general aviation costs would raise an additional $5.4 billion in budget receipts over the 1984-1988 period (see Table IX-2).

Inland Waterways. The user financing mechanism was only recently extended to inland waterways. Inland waterway user charges, in the form of a fuel tax, were established under the Inland Waterways Revenue Act of 1978. These charges took effect in 1981 and will be phased in over the next several years, rising from 4 cents per gallon at the outset to 10 cents per gallon in 1986 and thereafter.

Current inland waterway user fees fall far short of financing federal expenditures for inland waterways, however. The U.S. Army Corps of Engineers will spend an estimated $4.0 billion to build, operate, and maintain inland waterway facilities during the 1984-1988 period. By comparison, the current fuel tax will generate only about $280 million in budget receipts over the same period--about 7 percent of the projected federal outlays. And even in light of the planned increase in the waterway fuel tax, offsetting receipts are projected to fund only about 8 percent of federal inland waterway expenditures in 1988. Thus, significant savings could be realized through increased fees on inland waterway users. Such fees might not necessarily take the form of a fuel tax but instead could take the form of direct locking fees or segment tolls that reflect the actual costs of building, maintaining, or operating a particular waterway facility or segment. Full recovery of total federal expenditures for inland waterways would reduce the federal budget deficit by approximately $3.7 billion over the 1984-1988 period (see Table IX-2). Alternatively, setting fees to recover only half of federal expenditures would result in cumulative savings of $1.7 billion during 1984-1988.

Deep-Draft Navigation. The Corps of Engineers spends about $500 million a year to maintain and improve ports and channels that accommodate oceangoing vessels and Great Lakes shipping. The largest share of the corps' resources is devoted to maintenance dredging. Other corps' activities include construction and maintenance of jetties and breakwaters, channel widening, and anchorage construction.

Although user fees are not now collected to offset expenditures for the corps' activities, a strong case can be made for instituting them. Commercial shippers are readily identifiable users who benefit directly from the corps' programs. User fees would promote economic efficiency as well as equity, because users would pay the cost of the corps' services. Moreover, inasmuch as the Congress has broadly applied the user charge principle to other modes of transport, there is no economic (or technological) reason why this same rationale should not be applied to deep-draft ports and channels.

Assuming a constant real program level between 1983 and 1988, the corps will spend about $2.6 billion for deep-draft navigation during the 1984-1988 period--$1.9 billion for operation and maintenance and $0.7 billion for construction. Thus, a full-cost recovery fee would recoup $2.6 billion from 1984-1988 and would increase the average cost of all commodities using deep-draft facilities by about 22 cents per ton (see Table IX-2). If, however, fees were set to recoup only the cost of operation and maintenance, the federal deficit would be reduced by about $350 million in 1984 (at an average cost increase of 16 cents per ton of commodity carried) and $1.9 billion over the 1984-1988 period.

U.S. Coast Guard Services. The U.S. Coast Guard spends more than $1.1 billion a year on search-and-rescue activities, aids to navigation, marine safety, and environmental protection. Of this sum, more than 80 percent provides federal services or facilities to identifiable groups of civilian maritime users.

Coast Guard services provide substantial, and uncompensated, benefits to the commercial shipping industry. For example, without navigational aids--such as buoys and other channel markings--commercial shipping in U.S. inland and coastal waters would be substantially more hazardous, difficult, and costly than it is now. The capital and operating costs of these aids could thus be recovered from the shipping industry, just as highway users pay for the costs of roads.

The Coast Guard also engages in search-and-rescue operations for private mariners who are lost or otherwise in trouble; about 72 percent of the Coast Guard's search-and-rescue activities assist recreational boaters. These search-and-rescue costs could be recovered through registration fees on recreational boats that use coastal and inland waterways. Other fees could be assessed on commercial and fishing vessels.

Full recovery of the allocable federal costs for these navigation and recreational boating activities would reduce net federal expenditures by about $1.1 billion in 1984 and $5.8 billion in the 1984-1988 period (see Table IX-2).

RESOURCE MANAGEMENT

The federal government undertakes a variety of activities to develop and manage the nation's natural resources. Such activities include land conservation and forestry programs (Department of Agriculture); programs for management of national parks, wilderness areas, federal rangeland, and the Outer Continental Shelf (Department of the Interior); and production of electrical power and management of the Strategic Petroleum Reserve (Department of Energy). Some of these programs and activities are currently subject to user fees and other government charges; others are not. The existing user fees and charges together will bring in about $14.8 billion in 1983.

Current user fees and other government charges for resource management activities could be increased or new fees instituted to reduce net federal expenditures. One strategy would be to set prices for federal resources that have comparable private markets. This would result in efficient use of government resources and increases in government revenues. Several activities for which market prices could be charged are examined below.

Federal Irrigation Programs. Under the auspices of the Bureau of Reclamation, the federal government provides irrigation water for agriculture in the West. The bureau was established in 1902 to administer development of arid and semiarid lands in 17 western states; thus, to encourage development of the West, the bureau provided subsidized water. Irrigation water provided by bureau water projects was not sold at market rates nor even at cost. The federal government continues to subsidize water for western agriculture, even though the original purpose of the subsidy--settlement of western land--has long been fulfilled.

The government currently charges user fees that are below market rates for irrigation water delivered in the West. These low rates encourage wasteful use of water in regions with scarce natural water resources. For example, California farmers receiving federally subsidized water grow low-value crops such as cotton and rice (the latter is a particularly water-intensive crop), which can better be grown elsewhere. Moreover, these crops are subject to federal price supports, because excess supplies drive down prices. In this case, low prices for one government service (irrigation water) result in higher federal spending for another government program (agricultural price supports, examined in Chapter VI).

Raising fees for Bureau of Reclamation water could increase receipts to the federal government. Any such increase would be limited, however, by existing contracts that constrain future price increases for current water deliveries. Increased receipts would therefore depend, at least in the near term, on levels (and prices) of new water deliveries. Raising fees on all new contracts could, however, save roughly $12 million over the five-year period 1984-1988 (see Table IX-3).

Grazing Rights on Federal Lands. Several federal entities allow livestock grazing on land under their jurisdictions. The pricing policy for these grazing rights varies from office to office, however. Two entities, the Defense Department and the Bureau of Indian Affairs, receive market values for their grazing rights by auctioning them. The offices with the largest land holdings, however--the Forest Service and the Bureau of Land Management--allocate grazing rights by permit and collect fees based on the lessees' ability to pay. These are set according to beef cattle prices, forage values, and other costs associated with raising herds. In many cases, however, possession of a grazing permit, which is obtained by federal administrative process, is of substantial economic value to the holder. Competing ranchers, not so favored, must pay market rates and are at a comparative disadvantage. If federal grazing permits were auctioned, with the required minimum bid set equal to the current formula fee, the government could collect the difference between market rates and the current below-market grazing fees. Such a policy could raise as much as $3 million in additional receipts in 1984 and $53 million over the next five years (see Table IX-3). Alternatively, rather than auctioning grazing permits, the government might ensure higher collections by changing the formula used to calculate fee levels.

Power Marketing. The federal government, under the auspices of five power administrations, sells electrical power generated at dams built and operated by the Bureau of Reclamation and the Army Corps of Engineers. The five power marketing administrations are the Bonneville Power Administration, the Western Area Power Administration, the Southwestern Power Administration, the Southeastern Power Administration, and the Alaska Power Administration.

Existing laws require these agencies to cover costs and repay all federal investment through rates to electricity consumers. In recent years, however, revenues to the Bonneville Power Administration (the largest of the government's power marketing administrations) have not been sufficient to cover its costs, making it necessary for Bonneville to defer repayment of its federal investment. Between 1977 and 1981, Bonneville postponed about $500 million of its planned repayment and deferred over $200 million in interest payments. In recent years, Bonneville has increased its rates substantially, but revenues have continued to fall short of its obligations. Several reforms of its rate-setting standards could improve Bonneville's ability to meet these expenses. Such reforms could involve requiring rate tests (comparable to those used by the Tennessee Valley Authority); changing the method of estimating the cost of service; reevaluating repayment obligations; and allowing the enterprise to issue short-term debt (subject to appropriate standards and oversight) to cover operating needs. The impact of such changes cannot be estimated precisely because of the diverse variables and uncertainties. But if Bonneville had achieved the Tennessee Valley Authority's target ratio of income to interest costs during the 1977-1981 period, it would not have needed to postpone principal or interest payments. If Bonneville's rate structure were reformed so that its projected revenues covered its obligations, the additional revenues collected by Bonneville would reduce outlays by about $41 million in 1984 and $61 million in 1988 (see Table IX-3).

Federal Recreational Areas. Under the authority of the Department of the Interior, the federal government operates a broad assortment of

TABLE IX-3. BUDGET SAVINGS FROM RESOURCE MANAGEMENT USER FEES SET AT MARKET PRICES OR FULL COST RECOVERY (In millions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
			Market Price Charges			
Irrigation Water	--	3	3	3	3	12
Grazing Rights	3	6	9	15	20	53
Subtotal	3	9	12	18	23	65
			Full Cost Recovery Charges			
Outdoor Recreation Areas	30	60	94	97	100	381
Strategic Petroleum Reserve	300	300	300	300	300	1,500
Power Marketing	41	43	53	59	61	257
Subtotal	371	403	447	456	461	2,138
Total	374	412	459	474	484	2,203

recreational areas--parks, beaches, historic monuments, and the like--that attract approximately 800 million visitors each year. The government spends some $350 million a year to maintain these areas. Entrance fees, in varying amounts, are charged at only a small fraction of these federal facilities. In 1980, fewer than 5 percent of all visitors were charged entrance fees, producing federal revenues of only $5 million. Visitors who paid at all to enter these facilities paid an average of less than 20 cents per person. Because only certain areas charge fees, however, all visitors to all federal recreational areas pay about 1 cent per visit when receipts are averaged over all sites and visits.

Though charging fees is impractical in some instances (either because the recreational areas are too remote, or because access to them cannot be controlled), fees are already collected in many areas and could easily be raised to an average of 60 cents a visitor above the cost of collection. If this were done, federal receipts would rise by $30 million in 1984 and by

$381 million over the 1984-1988 period (see Table IX-3), bringing the nation's recreational areas closer to being self-sustaining.

Strategic Petroleum Reserve. The Strategic Petroleum Reserve (SPR), administered by the Department of Energy, is another instance of the government's providing a service--in this case, insurance against another oil import curtailment--without recovering the full costs of the service. The Congress has placed much of this program, which costs $2 billion to $4 billion annually, off budget, but the effect on federal financing needs remains the same as if it were on budget.

The cost of the SPR is made up of two parts: the cost of the oil itself (estimated at $2 billion to $4 billion a year) which is off budget, and the cost of constructing storage facilities for the oil (estimated at $240 million to $300 million a year) which remains on budget. Under current policy, the purchase cost of the oil would presumably be recovered were SPR stocks to be used; the oil could be sold to consumers at a price sufficient to recoup the government's full purchase cost, including interest. These sales would not recover storage construction costs, however.

The federal government could also recover the cost of SPR storage construction by imposing a tax, or fee, on current users of oil. Such a fee could take three forms: an import duty on crude oil and refined products; a tax on gasoline; or a fee on crude oil used by U.S. refiners, with an equivalent tax on imported refined products. Since the charge needed to pay the storage costs of SPR would be less than 6 cents per barrel, or 0.3 cents per gallon of gasoline, the impact on consumer prices would be nominal. Similarly, the effects on the automobile industry should not be significant. A tax of 6 cents per barrel on domestic and imported refined products would raise federal revenues by $0.3 billion in 1984 and $1.5 billion during the 1984-1988 period--about the cost of the SPR storage facilities during this period (see Table IX-3).

FINANCIAL, INFORMATIONAL, AND SUPPORT SERVICES

The federal government provides a wide range of financial, informational, and support services that benefit limited groups of users. These include such diverse activities as subsidized postal service; collection, processing, and distribution of economic data; processing and registration of patents and trademarks; preparation and distribution of aeronautical and nautical charts and maps; and grievance arbitration. Many of these services are provided most efficiently by the federal government; others--such as patent and trademark licensure--can only be provided under federal authority. Nevertheless, these services provide direct benefits to users who could

TABLE IX-4. BUDGET SAVINGS FROM FINANCIAL, INFORMATIONAL, AND SUPPORT SERVICE USER FEES SET TO RECOVER FULL FEDERAL COSTS (In millions of dollars)

Services	1984	1985	1986	1987	1988	Cumulative Five-Year Total
Postal Service	740	778	815	849	882	4,064
Patent and Trademark	8	8	8	9	9	42
Charts and Maps	44	44	44	44	44	220
Space Shuttle	73	237	394	373	303	1,380
Tax Rulings and Determinations	13	13	14	15	15	70
Total	878	1,080	1,275	1,290	1,253	5,776

be identified and charged for the costs incurred by the federal government. Several examples of federal services for which existing fees could be increased, or new fees imposed, are examined below.

U.S. Postal Service. The U.S. Postal Service is basically a self-supporting enterprise, with the exception of two major categories of service for which federal appropriations have been provided. The first category covers public service operations that are not remunerative but judged to be in the national public interest, such as postal facilities in remote areas and Saturday mail delivery. The second category, conceived to promote the flow of news, educational, charitable, and cultural materials, covers reduced-cost mail for several groups of users. This category includes low-rate service for handicapped persons, for religious and other not-for-profit organizations, for small-circulation newspapers, and for libraries. Payments for the latter services are termed "revenue forgone" subsidies. (Chapter VIII considers other aspects of federal subsidies to the Postal Service.)

Originally, the public service payment was authorized at 10 percent of the Postal Service's 1971 budget, or $920 million. The Postal Reorganization Act of 1970 provided that this subsidy would continue at $920 million until 1980, when it would begin to be reduced by 10 percent yearly until reaching $460 million in 1984. Past and current Administrations have significantly speeded up the reduction in this subsidy, however, and the

Congress provided only $12 million for public service costs in 1982. No funds for this subsidy have been provided to date for 1983, although the Appropriations Committees provided language (in Senate Report 97-547) requiring the Postal Service to maintain current levels of service and to retain small post offices. The language also provides that the subsidy may be restored at a later date.

The revenue forgone subsidies are of two sorts--a "phasing" appropriation and a "continuing" appropriation. The phasing appropriation for revenue forgone was intended to provide gradual reductions in postal rate subsidies. The continuing appropriation permanently authorizes U.S. Treasury funding of a rate differential benefiting all categories of preferred mailers. Essentially, the preferred mailer is not asked to contribute through postal rates to the fixed overhead costs of postal service. The taxpayer makes up the difference between what the preferred mailer pays and what the commercial rate would be for the same piece of mail. For 1983, the Congress appropriated $789 million for revenue forgone subsidies (including both phasing and continuing appropriations).

If the federal government eliminated all revenue forgone appropriations (except those supporting free mail for the blind and handicapped), the savings in 1984 would total $740 million. Savings for 1984-1988 would total $4.1 billion (see Table IX-4). These reductions in federal subsidies would be accompanied by rate increases, particularly for preferential mail.

Patent and Trademark Registration. The Patent and Trademark Office of the Commerce Department provides special benefits, beyond those accruing to business and industry, to individuals who obtain patent protection for inventions and trademark registration. Patent protection affords a 17-year monopoly giving the patent holder exclusive rights to returns from commercial application of the invention.

Each year, the Patent and Trademark Office receives more than 100,000 patent applications and more than 50,000 applications for trademarks. The costs to the federal government of processing these applications were about $90 million in 1982. Some of these costs--about $28.5 million in 1982--were offset by receipts from patent and trademark application fees. Public Law 97-247, (Patent and Trademark Office Appropriation Authorization), signed August 27, 1982, increased these fees so that all costs (except those incurred in servicing small businesses, individuals, and universities) would be recovered over 17 years--the life of the patent. Fees for small businesses, individuals, and universities are limited to half of full cost recovery. If, in a departure from current policy, fees were increased to recover 100 percent of costs for all users, receipts to the federal government would increase by about $8 million in 1984 and $42 million over the 1984-1988 period (see Table IX-4).

Charts and Maps. The National Oceanic and Atmospheric Administration, an office of the Department of Commerce, prepares aeronautical charts and nautical maps for use in aviation and maritime activities. The federal government will spend about $70 million on mapping and charting services in 1983. About a third of these costs--or $26 million--will be recovered from current user fees.

This subsidy could be completely offset by raising the purchase prices of maps and charts. Current charges now average about $2 for aeronautical charts and $5 for nautical maps. If these charges were increased to $9 and $37 respectively, the federal government could recover the full cost of the mapping and charting program. Although these charges would represent a large increase over current levels, they would remain only a small portion of the overall costs of operating aircraft or marine vessels. Full-cost recovery would increase federal receipts by $44 million in 1984 and $220 million during the 1984-1988 period (see Table IX-4).

Income Tax Rulings and Determinations. Upon request from a private firm or organization, the Internal Revenue Service (IRS) provides income tax rulings and determinations. Tax rulings are prepared by the IRS when a given firm or organization requests a ruling on particular points of tax law. Determination letters are prepared to establish the requestor's tax-exempt status or its eligibility as a pension trust plan organization. In 1982, the IRS received 215,072 requests for such rulings and determinations. Some 159,400 requests involved letters of determination or rulings on pension trust plan organizations, while 55,672 sought determinations on tax exemptions. In addition, 30,555 preliminary rulings on accounting periods and methods were requested by individuals and accounting firms. Such, requests for preliminary tax rulings and determination letters are likely to increase significantly in the near future because of the recent changes in tax law enacted last year under TEFRA.

The tax rulings and determinations process has imposed large demands on government resources; the cost of this service was estimated at about $31 million in 1982. The costs associated with requests for letters of determination and rulings from tax exempt organizations were funded, however, from a 2 percent excise tax on private foundations, thereby reducing the government's net cost to $23 million. Given the sizable cost of this service to the government and the financial benefits that requesting firms and organizations stand to realize, the IRS could charge a fee to recover some or all of the costs of rulings and determinations not now funded from the 2 percent excise tax. Such fees would offset federal expenditures for this service, while doubtless also discouraging some of the demand and thereby forestalling backlogs and delays. If charges were instituted to recover 50 percent of the federal cost of providing these rulings and determinations (requiring a charge of about $60 per applications), additional collections during 1984 would total about $12.8 million. Any future increase in the number of applications or in the government's cost for this service would result in higher future collections.

Space Shuttle. The National Aeronautics and Space Administration (NASA) launches satellites both for military purposes and for commercial use. NASA is expected to use the space shuttle for most future satellite launchings. Firms currently pay NASA for launching their satellites, but NASA has set charges below the full federal cost of this service. Such undercharges stem from several factors. First, some of the launching charges were originally set several years ago, when estimates of the costs for the shuttle program were more optimistic than they are now. Prices have not been revised upward, however, though cost estimates for the shuttle program have risen. Second, no attempt has been made to recover the research and development costs associated with the shuttle program, estimated at about $15.3 billion over the last 12 years. And third, NASA appears to want to maintain relatively low user charges in order to encourage maximum use of the space shuttle.

Rate increases for commercial satellite launchings by the space shuttle seem appropriate, since the clear beneficiary is private industry. Rate increases for NASA's commercial launchings may be constrained, however, by the availability of traditional rocket launchers. (A consortium of European countries is likely to follow NASA's price lead.) Nevertheless, the current charges of $21 million for launching a typical communications satellite in 1986 could probably be increased by about 60 percent without risking losses in revenues. These charges would not include recovery of research and development expenses and, because of existing contracts, could not be applied to launches before 1986. Such increases would generate total additional collections of about $1.4 billion over the 1984-1988 period.

Regulatory Oversight

The federal government undertakes a variety of regulatory oversight activities. These range from financial and economic regulation (such as that carried out by the Securities and Exchange Commission and the Commodity Futures Trading Commission) to environmental and natural resource regulation (as carried out by the Environmental Protection Agency). For the most part, these activities or services are not currently subject to user fees. In 1983, only $.3 billion will be collected in user fees levied in this area.

Application of the user fee principle to federal regulatory oversight activities could be contentious. On the one hand, it can be argued that the federal government's regulatory oversight activities grew out of a concern for the public's interest and are intended to protect the public; hence, the cost of these activities should be paid by the public. On the other hand, it can be argued that the regulated industries or markets should bear the cost of federal regulation--because they are placing the public at risk through their activities, or because, as market participants, they either benefit directly from the regulatory activities or have the ability to pass along the costs of regulation to the direct beneficiaries, their consumers. To the extent that the Congress favors the latter argument, federal expenditures for a variety of regulatory oversight activities could be recouped from user fees. A couple of areas in which such fees might be levied are examined below.

Federal Energy Regulatory Commission. The Federal Energy Regulatory Commission, an independent body within the Department of Energy, regulates oil pipelines, licenses hydroelectric power projects, and regulates the rates and service standards for wholesale electric sales in interstate commerce. The commission also has jurisdiction over interstate aspects of the natural gas industry, as well as regulatory control over intrastate producer sales of natural gas.

Federal outlays for the commission will total about $80 million in 1983. Approximately one-half of these costs--or $42 million--are expected to be offset by revenues from the commission's existing and planned fees for pipeline approvals and hydropower licenses. If these existing fees were increased further, offsetting receipts could finance the commission's total costs. The federal savings would be $37 million in 1984 and about $192 million over the 1984-1988 period (see Table IX-5).

Commodity Futures Trading Commission. The Commodity Futures Trading Commission, an independent regulatory agency, carries out the provisions of the Commodity Exchange Act of 1936. The purposes of the commission are to assure the efficiency and integrity of the futures market and to protect market participants against fraud, deception, and other abusive trade practices.

Federal outlays for the Commodity Futures Trading Commission will total about $22 million in 1983. About $1 million of these costs will be recovered in receipts collected from administrative fees for registration and informational services. If these fees were raised and new fees (such as transaction fees) instituted, offsetting receipts could be increased to fund the total costs of the commission. The federal savings would be $23 million in 1984 and about $122 million over the 1984-1988 period (see Table IX-5).

TABLE IX-5. BUDGET SAVINGS FROM REGULATORY OVERSIGHT ACTIVITY USER FEES SET TO RECOVER FULL FEDERAL COSTS (In millions of dollars)

Oversight Entity	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Federal Energy Regulatory Commission	37	38	38	39	40	192
Commodity Futures Trading Commission	23	24	24	25	26	122
Total	60	62	62	64	66	314

CONCLUDING COMMENTS

Broader application of user fees and other charges for federally provided services offers the potential for significant reductions in the budget deficit, while simultaneously promoting efficient investment. Budget receipts and offsetting receipts could be increased by as much as $31 billion over the 1984-1988 period through such fees and charges (see Table IX-6). A large portion of these collections--about $23 billion over five years--could be realized in the area of infrastructure construction, maintenance, and operation. Another $5.8 billion in collections could be realized in financial, informational, and support programs. Other governmental undertakings offer significantly less potential for increased collections from user fees or other charges: some $2.2 billion could be collected in the area of resource management, while fees for various federal regulatory activities examined here could increase collections by about $.3 billion.

TABLE IX-6. SUMMARY OF BUDGET SAVINGS FROM USER FEES, BY FEDERAL PROGRAM AREA (In billions of dollars)

Program Area	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
Public Infrastructure	4.44	4.50	4.61	4.59	4.72	22.86
Resource Management	.37	.41	.46	.47	.48	2.20
Financial, Informational, and Support Services	.88	1.08	1.28	1.29	1.25	5.78
Regulatory Oversight	.06	.06	.06	.06	.07	.31
Total	5.75	6.05	6.41	6.41	6.52	31.15

CHAPTER X. REVENUES

Federal revenues as a percentage of the gross national product are projected to decline from a post-World War II high of 20.9 percent, reached in fiscal year 1981, to 18.3 percent by 1988. The projected decline is attributable primarily to the large multi-year individual and corporate income tax reductions enacted in the Economic Recovery Tax Act of 1981 (ERTA)--reductions that were offset, but only partly, by the increases enacted the next year in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

Though federal taxes as a percentage of GNP during the 1984-1988 period are projected to decline to the levels that prevailed in the 1960s and 1970s, federal expenditures during the same period are projected to reach more than 24 percent of GNP if no additional spending reductions are made. The budget deficits that would result--5 to 6 percent of GNP--would be the highest since World War II.

These projected deficits led last year to a search for new ways to increase federal revenues, a search that is likely to continue this year. At the same time, the economy is in the longest and deepest recession since World War II. Increasing taxes during this recession could well make it worse and delay economic recovery. Even if tax increases are postponed until a recovery is under way, such increases could, if not carefully designed, inhibit long-term investment and economic growth. Any tax increases aimed at dealing with the long-term deficit problem should therefore be designed to minimize adverse effects on recovery and long-term growth.

Federal government revenues come principally from individual income taxes (currently about 47 percent of total revenues), social insurance taxes (about 35 percent), and corporate income taxes (about 7 percent). The remaining 11 percent comes from various sources, including excise taxes, estate and gift taxes, and user charges (see Table X-1). (User charges are considered in detail in Chapter IX.)

Certain provisions of the individual and corporate income taxes allow special tax reductions for some individuals and businesses, either to relieve hardships or to offer incentives for particular kinds of activities. Examples of such provisions, referred to as "tax expenditures," include the deduction for medical expenses and the investment tax credit for purchases of business

TABLE X-1. FEDERAL REVENUES, BY SOURCE

Revenue Source	Actual			Estimated	Baseline Projection				
By Type of Tax	1980	1981	1982	1983	1984	1985	1986	1987	1988
In Billions of Dollars									
Individual Income	244.1	285.9	298.1	285.8	294.9	320.8	345.8	371.6	400.0
Corporate Income	64.6	61.1	49.2	40.3	55.8	65.2	74.0	83.1	87.7
Social Insurance	157.8	182.7	201.1	212.1	232.1	258.2	283.2	303.4	326.2
Excise	24.3	40.8	36.3	37.7	41.6	41.5	36.4	35.5	35.9
Estate and Gift	6.4	6.8	8.0	6.1	5.9	5.6	5.0	4.6	4.3
Other	19.9	21.9	25.0	24.1	23.0	23.6	23.8	23.8	24.1
Total	517.1	599.3	617.8	606.2	653.4	714.9	768.3	821.9	878.2
As a Percent of Total Revenues									
Individual Income	47.2	47.7	48.3	47.2	45.1	44.9	45.0	45.2	45.6
Corporate Income	12.5	10.2	8.0	6.6	8.5	9.1	9.6	10.1	10.0
Social Insurance	30.5	30.5	32.6	35.0	35.5	36.1	36.9	36.9	37.1
Excise	4.7	6.8	5.9	6.2	6.4	5.8	4.7	4.3	4.1
Estate and Gift	1.2	1.1	1.3	1.0	0.9	0.8	0.7	0.6	0.5
Other	3.9	3.7	4.0	4.0	3.5	3.3	3.1	2.9	2.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
As a Percent of GNP									
Individual Income	9.5	10.0	9.8	8.9	8.4	8.4	8.3	8.3	8.3
Corporate Income	2.5	2.1	1.6	1.3	1.6	1.7	1.8	1.9	1.8
Social Insurance	6.1	6.4	6.6	6.6	6.6	6.8	6.8	6.8	6.8
Excise	0.9	1.4	1.2	1.2	1.2	1.1	0.9	0.8	0.7
Estate and Gift	0.2	0.2	0.3	0.2	0.2	0.1	0.1	0.1	0.1
Other	0.8	0.8	0.8	0.8	0.7	0.6	0.6	0.5	0.5
Total	20.1	20.9	20.4	19.0	18.7	18.7	18.5	18.4	18.3

machinery and equipment. Tax expenditures allocate federal resources in much the same way that spending programs do, and they add to the deficit. Thus, they can be analyzed for possible budget savings in the same way that spending programs are.

BUDGET HISTORY AND PROJECTIONS

The effects of the ERTA and TEFRA legislation dominate the budgetary story in the 1980-1988 period. ERTA is projected to reduce tax collections as a percentage of GNP by 3.9 percentage points below what they would otherwise be in 1984, and 5.6 points in 1988. This effect is only partially offset by TEFRA, which increases projected revenues by 1.1 percent of GNP in 1984 and 1.2 percent in 1988 (see Table X-2). The projected net effect of the two acts is to reduce revenues from the 1981 high of 20.9 percent of GNP to an estimated 18.3 percent in 1988.

Recent History, 1980-1982

Federal revenues grew from $517.1 billion in 1980 to $599.3 billion in 1981 and $617.8 billion in 1982. As a percentage of GNP, total revenues rose from 20.1 percent in 1980 to 20.9 percent in 1981 and then slipped to 20.4 percent in 1982 because of the $38.4 billion 1982 tax reduction resulting from ERTA. As shown in Table X-2, $28.9 billion of the 1982 reductions were in the individual income tax and $9.2 billion in the corporate income tax. Tax expenditures were increased significantly in ERTA, which added 11 new tax expenditures and expanded 21 existing ones, while reducing only two. (See Table X-2 for the estimated revenue effects.)

The Current Situation

In the budget resolution for 1983, the Congress, facing large projected deficits for the current and coming years, required revenue increases totaling nearly $100 billion for 1983-1985. This target was met in TEFRA, which restored about one-fourth of the total revenue reduction for 1983-1985 enacted the year before in ERTA. Approximately 44 percent of the 1983-1985 revenue increases in TEFRA were in the corporate income tax, restoring about 55 percent of the corporate income tax reductions enacted the year before for that period. With 13 provisions that lowered tax expenditures and only two that raised them, TEFRA also reversed the previous year's pattern in dealing with tax expenditures.

TABLE X-2. REVENUE EFFECTS OF THE ECONOMIC RECOVERY TAX ACT OF 1981 AND THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982, BY REVENUE SOURCE (In billions of dollars)

Type of Tax	1982	1983	1984	1985	1986	1987	1988
ERTA							
Individual Income	-28.9	-68.0	-105.2	-126.5	-155.3	-181.7	-213.4
Corporate Income	-9.2	-17.2	-25.7	-34.5	-42.5	-45.1	-43.2
Social Insurance	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Other	-0.8	-3.0	-4.2	-6.0	-7.9	-9.5	-10.9
Total	-38.4	-87.8	-134.8	-166.6	-205.2	-235.8	-267.0
Percent of GNP	1.3	2.7	3.9	4.4	5.0	5.3	5.6
TEFRA							
Individual Income	--	4.9	12.7	12.5	14.8	17.8	20.1
Corporate Income	--	7.4	16.3	19.2	26.2	31.6	31.0
Social Insurance	--	1.9	3.1	3.6	2.9	2.6	2.3
Other	--	3.7	5.6	6.4	2.9	2.1	2.3
Total	--	17.9	37.7	41.7	46.9	54.2	55.7
Percent of GNP	--	0.6	1.1	1.1	1.1	1.2	1.2
ADDENDUM--CHANGES IN TAX EXPENDITURES a/							
ERTA							
Increases	-12.8	-28.5	-40.6	-51.7	-65.7	NA	NA
Reductions	1.2	2.2	0.3	0.2	0.2	NA	NA
TEFRA							
Increases	--	-0.2	-0.6	-0.6	-0.3	-0.1	NA
Reductions	--	4.0	11.9	15.9	23.6	29.5	NA

a. The revenue effects of the changes in tax expenditures shown here are included in the overall effects of the acts shown above.

Revenues for 1983 are now estimated to be $606.2 billion, 19.0 percent of GNP. The share of total revenues represented by individual and corporate incomes taxes is expected to drop somewhat from the 1982 level, while the social insurance share is expected to increase somewhat.

Baseline Projections, 1984-1988

Total federal revenues as a percentage of GNP are projected to continue dropping between 1984 and 1988, from 18.7 percent in 1984 to 18.3 percent in 1988. Revenues as a percent of GNP were as low as 17.7 percent in 1965, and were below 18.3 percent in five other years in the 1960s and 1970s. Individual income taxes are projected to remain essentially steady as a percentage of total revenues during the 1984-1988 period, while the corporate income tax share is projected to rise from 8.5 percent in 1984 to 10.0 percent by 1988. The social insurance share is projected to increase by 1.6 percentage points, from 35.5 percent in 1984 to 37.1 percent in 1988.

DEFICIT REDUCTION STRATEGIES

In view of the pressing need to reduce future deficits, while at the same time encouraging both near-term economic recovery and future growth, any tax increases in a budget reduction strategy should be designed with the following three goals (and cautions) in mind:

- Reduce disposable consumer incomes only when the economy has begun to revive;
- Provide a long-term source of revenues for the tax system (which cannot be accomplished by temporary measures, such as surtaxes); and
- Minimize disincentives to work, save, and invest, and improve the allocation of investment resources.

Any tax measure that reduced consumer demand in the near-term could prolong the current recession. At the same time, tax policy must be predictable so that businesses and investors can plan with the least possible uncertainty. So any tax increases that are adopted should take effect only after the economy has begun to recover and grow again, but should be enacted early to give business planners notice of the new conditions and to signal financial markets that the deficit is being reduced. Of course, this strategy cannot obviate all risk that the mere knowledge of future tax increases might depress current consumption and slow the recovery.

The credibility of future tax increases as deficit-reducing measures may also turn on their form. A tax increase that would take effect only if certain contingencies were fulfilled may not be viewed as a reliable way of reducing future deficits. A tax increase enacted now, but scheduled to take effect only in the future, would probably be viewed as more credible, even though the Congress could decide to rescind it before it took effect. The likelihood of such a rescission might also depend somewhat on the form of the tax; a surtax might be easier to rescind than some more basic, structural, change in the tax code.

Tax policy considerations may also be an important concern in formulating budget reduction strategies. Revenue-increasing measures that are consistent with the three basic tax policy goals--equity, efficiency, and simplicity--are more likely to stand up under long-term scrutiny and, thereby, to yield the reliable long-term revenues needed to reduce projected future deficits. Also, the goal of economic efficiency, which is served when taxes have the least possible distortionary impact on economic decisions, is generally consistent with the goal of devising tax increases that minimize disincentives to work, save, and invest, and that improve the allocation of investment resources.

Though all proposals to increase taxes can be judged according to these economic, budgetary, and tax policy criteria, a look at tax increases in the context of how they could affect various groups of individuals and industries can also be useful. Tax increases can be part of an across-the-board strategy, in which relatively small increases per taxpayer are spread over a large number of taxpayers. Or they can be part of a targeted strategy, in which larger increases per taxpayer are concentrated more selectively on particular groups of individuals or economic sectors. In the discussion that follows, tax increase options are classified as either across-the-board or targeted. Each option is evaluated in terms of the economic, budgetary, and tax policy criteria described above.

ACROSS-THE-BOARD STRATEGIES

An across-the-board approach to increasing revenues may be one or a small number of policy steps that increase taxes for much or even most of the population. Such a broad strategy would have the advantage of spreading the pain of deficit reduction thinly, and thus reducing the number of people or groups likely to raise intense opposition. It also has the consequent disadvantage, of course, that many people have some reason to oppose the policy, even though each person's additional burden might be small. Another potential advantage of the across-the-board approach is that one large policy step might be easier to achieve than several narrowly focused revenue-raising measures.

An across-the-board strategy could either build upon existing tax provisions (an "incremental" approach), or it could entail an entirely new or fundamentally restructured tax. An incremental approach--for example, an increase in scheduled individual income tax rates or the addition of a corporate minimum tax--would involve no major change in the existing tax structure. New taxes could include a value-added tax (VAT) or a personal consumption tax; or the individual income tax could be fundamentally redesigned.

This last alternative could involve several relatively large base-broadening steps. The total yield of the changes could be set to exceed the target revenue gain, and the excess revenue could then be returned through across-the-board income tax rate cuts. This approach has the advantage of offering some compensation, in the form of a rate reduction, to taxpayers who are affected by the individual revenue-raising steps; simply broadening the tax base and providing no compensating rate cuts would leave all affected taxpayers worse off. This broader-base lower-rate strategy thus might spread the pain even more widely and thinly than base broadening alone. It might also have the advantage of making the tax system more fair and of increasing the incentive for work, saving, and investment through the lower tax rates. On the other hand, it would involve more individual policy steps and therefore would be more complicated than a targeted approach; it would also adversely affect more people than a targeted approach (though part of the effect would be offset), and therefore might arouse more political opposition.

Table X-3 shows the estimated revenue effects of a number of across-the-board options.

Incremental Modifications of Existing Taxes

Repeal the Third-Year ERTA Tax Cut. One incremental step to raise revenues across the board would be to repeal the third installment of the individual income tax rate cuts provided in 1981 under ERTA. The legislation called for a 5 percent across-the-board cut in tax rates in October 1981, a further 10 percent in July 1982, and a final 10 percent in July 1983. Elimination of the last installment would increase revenues by $30 billion in 1984 and $40 billion in 1988. In effect, income tax revenues would be about 10 percent higher than now projected for 1984 and thereafter, because the tax rates would be cut by less than was planned. (The precise amount of the tax change is actually much more complicated,

TABLE X-3. ESTIMATED REVENUE GAINS FROM BROAD-BASED TAX INCREASES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Repeal July 1, 1983 Rate Reduction a/	30	33	35	38	40	177
Cap Third-Year Tax Rate Cut at $700	6	7	7	8	9	37
Repeal Indexing a/	--	6	17	28	40	90
Impose Limit on Deductions and Credits	b/	b/	b/	b/	b/	b/
Impose 10 Percent Individual Income Tax Surtax c/	15	33	36	38	41	163
Impose 10 Percent Corporate Income Tax Surtax d/	4	8	9	10	11	42
Impose Corporate Minimum Tax	b/	b/	b/	b/	b/	b/
Impose Value-Added Tax	b/	b/	b/	b/	b/	b/
Replace Income Tax with Expenditure Tax	b/	b/	b/	b/	b/	b/
Introduce Broad-Based Low-Rate Income Tax	b/	b/	b/	b/	b/	b/

SOURCE: Staff of the Joint Committee on Taxation (JCT) and Congressional Budget Office. Assumes January 1, 1984 effective dates.

a. JCT estimate. CBO's estimate is about 10 percent higher because of different estimating techniques.

b. Revenue gain depends on details of proposal.

c. Calculated as a percent of tax liability (before credits) rather than as a percent of taxable income.

d. Calculated as a percent of tax liability before investment tax credits.

in part because the scheduled tax withholding cut is due to occur in the middle of calendar year 1983).

Repeal of the third year of the tax cut could prolong the current recession or dampen any recovery. It would, however, substantially reduce projected future-year deficits, thus easing upward pressure on long-term interest rates. To the extent that high interest rates are impeding economic recovery, therefore, repeal of the third year of the tax cut could have some beneficial effect.

An equity problem could arise from repeal of the third-year cut. The highest tax rate of 50 percent would not change (though it would take effect at a somewhat lower income level); it was reduced, from 70 percent, effective January 1, 1982. That initial reduction of the highest rate provided high-income taxpayers with the greater part of their three-year tax cut immediately, while those with lower incomes have had to wait for the full phase-in to be completed. So if the last year of rate cuts were repealed, those with the very highest incomes would have received more of their originally planned three-year tax cut than would those with more modest incomes.

A Cap on the Third-Year Tax Cut. Many alternatives to a complete repeal of the third-year ERTA tax cut are possible. One is to cap the 1983 tax cut at some arbitrary dollar amount; a cap of about $700 for joint tax returns (with an appropriate adjustment for single taxpayers) has been proposed by several Members of Congress. Under one simple variation of this proposal, all income below some given level would be taxed at the 1983 tax rates; for example, the level could be set for couples filing jointly at $35,200 of taxable income, at which level the 1983 tax cut compared with the 1982 law would be $699. The tax rates on income above that level would revert to those in the 1982 law, so no taxpayer would receive a tax cut greater than $699. A cap could be set at any amount and could apply to 1983 or 1984 tax rates.

To some extent, such a cap would mitigate the criticism that total repeal of the third-year tax cut would take a large share of the full tax cut from average taxpayers; those who would lose the biggest share of their three-year tax cut under this cap proposal are those in the upper-middle-income range (above $35,200 but below $109,400 on 1983 joint returns) who fall short of the highest tax bracket. Another aspect of the cap proposal to consider is that it would introduce a large jump in tax rates at one particular income level. With the $699 cap, for example, the marginal tax rate would jump from the 1983 level of 30 percent for income between $29,900 and $35,200 to the 1982 level of 39 percent for income between $35,200 and $45,800.

A cap on the third-year cut would recover far less revenue than would complete repeal, because the portion of that tax cut below $700 per joint return would still be allowed; the revenue gain from a $700 cap on the last 10 percent of the tax cut would be about $6 billion in 1984 and $9 billion in 1988. The economic effects would thus be much more modest than those of complete repeal. If significantly more revenue was to be raised, the marginal tax rates would have to be increased for taxable income below the $35,200 level; only about 15 percent of all income is taxed at rates above that level, and so the potential yield of tax increases exclusively above that level is strictly limited. If it was considered desirable to prevent upper-income taxpayers from receiving any of the 1983 tax cut, the tax rates in the 30 to 50 percent brackets would have to be raised even further. To recover some of the 1982 tax cut for the very highest-income taxpayers, the maximum tax rate would have to be increased above the 50 percent level. Of course, any number of alternative tax rate changes could be formulated to raise additional revenues from any segment of the income scale.

Repeal of Indexing. An automatic rise (indexation) in the personal exemption and tax rate brackets is provided in ERTA, to be effective in calendar year 1985. Indexing is estimated to decrease federal revenues from individual income taxes by $6 billion in fiscal year 1985 and $40 billion in 1988.

Indexing has considerable appeal as a device to prevent the unlegislated increases in real individual income tax liabilities that result solely from the effects of inflation on the tax system (commonly called "bracket creep"). If the federal government is considered likely to be short of tax revenues in 1985 and thereafter, however, the revenue gain from repealing indexing might seem desirable both in its timing and its sensitivity to economic conditions. Repealing indexing would not increase taxes in 1983 and 1984, when the economic recovery is likely to be fragile. Rather, it would raise revenues in 1985 and later years, when the prospect of continuing large budget deficits even with economic recovery is potentially most dangerous. Further, repealing indexing would increase taxes relatively more if too-rapid economic growth led to a rekindling of inflation, and relatively less if the economy grew slowly with little inflation. Repealing indexing now, rather than in 1984 or 1985, would give the financial markets advance notice of initiatives to reduce budget deficits, and thus might lead to lower interest rates.

If repeal of indexing were thought undesirable, postponement of the effective date from 1985 to 1986 could be an alternative. In effect, postponement would allow the real tax cuts due to ERTA--which are now larger than anticipated before the slowdown of inflation--to be somewhat eroded by future inflation until they reach a scale more like that originally anticipated. A one-year postponement of indexing would push the revenue losses due to inflation further into the future, saving $6 billion in 1985 and about $10 billion in 1986.

The projected tax increases from bracket creep are now only about half as large as they were anticipated to be in 1981 when ERTA was enacted. The accumulated bracket creep in 1985, starting from October 1, 1981 (the effective date of the first installment of the ERTA tax cut), is now estimated to be $47 billion, for example, $42 billion less than it was projected to be when ERTA was enacted (see Table X-4). The real ERTA tax cut is therefore substantially larger than it was originally expected to be. As a result, a case could be made that indexing of the brackets and exemptions is needed less urgently than was originally thought. (It can be argued that ERTA must also compensate for the cumulative bracket creep since January 1, 1979, when the last tax cut before ERTA took effect. From that perspective, as Table X-4 shows, the amount of bracket creep tax increase for which ERTA must compensate is much larger; but the slowdown of inflation still makes indexing less urgently needed than if prices were rising faster.)

A possible drawback to the repeal or postponement of indexing is its relative effects on taxpayers at the low and high ends of the income spectrum. Compared with indexation of the exemptions and the tax rate brackets, the three-year tax rate cuts under ERTA were more generous to upper-income taxpayers and less generous to those with lower incomes. If indexing were repealed, one might argue that taxpayers with lower incomes would continue to be less than fully compensated for the bracket creep caused by inflation since the late 1970s.

Indexing can also be justified as a way of continuing the pressure for discipline in federal spending and tax policy. It assures that real individual income tax revenues increase at roughly the rate of growth in real incomes, thus requiring that spending increases be similarly limited if future deficits are not to increase. It also limits the opportunities for increases in tax expenditures and other special-purpose tax provisions and imposes pressure to reduce those that now exist.

A Limit on Tax Deductions and Credits. A somewhat less broadly based incremental approach to raising revenues would be some form of limit on all itemized deductions and tax credits. Such an approach would affect fewer taxpayers than would a rate increase, because only about 31 percent of all tax filers now claim itemized deductions, and only about 21 percent claim any tax credits.

TABLE X-4. REVENUE EFFECTS OF TAX CUTS UNDER ECONOMIC RECOVERY TAX ACT OF 1981 COMPARED WITH INFLATION-INDUCED INCOME TAX INCREASES (In billions of dollars)

	1983	1984	1985	1986	1987	1988
Economic Recovery Tax Act						
Individual Income Tax Rate Reductions	60	91	102	114	124	138
Indexing a/	--	--	8	19	32	45
Estimated Income Tax Increases from Bracket Creep, Current Inflation Assumptions b/	18	31	47	64	80	101
Reduction in Estimated Bracket Creep Since 1981 c/	24	35	42	52	NA	NA
ADDENDUM						
Additional Income Tax Increases from Bracket Creep Beginning January 1, 1979, Current Inflation Assumptions d/	63	68	73	80	86	92

SOURCE: Congressional Budget Office.

a. This estimate differs from the JCT estimate for repeal of indexing in Table X-3 because of different estimating techniques and interaction between indexing and other individual income tax provisions.

b. Estimated by calculating the difference between the income tax revenues that would be collected in the absence of the Economic Recovery Tax Act, and those that would be collected if the income tax were indexed for inflation beginning in October 1, 1981. Assumes calendar year increases in the Consumer Price Index of the following amounts:

1983	1984	1985	1986	1987	1988
3.0	3.2	3.3	3.5	3.6	3.7

c. CBO, Baseline Budget Projections: Fiscal Years 1982-1986, July 1981 assumed calendar year increases in the CPI of the following amounts:

1983	1984	1985	1986
6.2	5.5	4.7	4.2

d. Shows additional effect of bracket creep measured from effective date of last pre-ERTA income tax reduction. If it is thought that ERTA should also compensate for this bracket creep, these numbers should be added to the post-October 1981 bracket creep shown above.

Significant revenue gains could result from limiting deductions and credits. Excess itemized deductions--that is, itemized deductions over and above the "zero bracket" amount--totaled more than $125 billion in 1980 (the latest year for which actual data are available). This implies a revenue loss of more than $30 billion (assuming conservatively that those deductions are claimed on average against a 25 percent tax rate). In the same year, tax credits came to more than $7 billion. Thus, a cutback of 20 percent in the value of these tax benefits would raise in excess of $7 billion.

The rationale for limiting deductions and credits is that such tax preferences are special provisions that do not benefit all taxpayers. If belt-tightening is needed, those preferences could be a fair place to start. Taxpayers who itemize deductions tend to have higher incomes than those who do not, and so itemizers may be better able to bear the additional burden of narrowing the deficit. Thus, this approach can be argued on grounds of equity. The burden of this approach would be more broadly spread by marginally reducing each deduction and credit, rather than eliminating some and leaving others intact.

An economic efficiency argument could be made as well, in that deductions and credits can sometimes create incentives that distort economic activity away from the outcomes suggested by the free market. Limiting such preferences, therefore, would reduce the role of the federal government in the allocation of resources. Further, reducing the revenue losses attributable to deductions and credits could permit lower, less distorting, tax rates on other sources of income. So, while such a limit might be seen in the short run merely as a revenue raiser, in the longer view it could take on greater significance as a step toward some form of simplified, broad-based tax.

One precedent for a limitation scheme is a Kennedy Administration proposal that was dropped from what eventually became the tax cut of 1964. It would have allowed itemized deductions to be used only to the extent that they exceeded 5 percent of income (though alternative figures could certainly be proposed); the percentage of income would in effect become a "floor" under itemized deductions. Such a floor would suggest that all taxpayers were likely to have itemizable deductions equal to that fraction of income, and that only extraordinary amounts of itemizable deductions--those above that floor--should be deductible.

The limitation approach would likely be subject to some objection, probably relating to the roles that the different itemized deductions and credits play in the tax system. Some itemized deductions and credits are needed to measure true income or to compute tax liability appropriately. The itemized deduction for employee business expenses, for example, derives from the notion that certain costs (such as for special work clothes or tools) of earning wage or salary income are not part of net income and should not be taxed. The foreign tax credit, similarly, is allowed so that U.S. tax is reduced by one dollar if a dollar of foreign tax liability is incurred. Allowing only a fraction of such deductions or credits would seem to violate some of the basic premises of the tax system. Other deductions, such as those for medical expenses and casualty losses, are intended to relieve hardship and have their own floors with respect to income. Limiting those deductions (especially after they were cut back in TEFRA) might seem to be targeting a revenue-raising measure on hardship. Other itemized deductions--particularly the charitable contributions deduction--are seen as incentives to promote socially desirable behavior; limiting those deductions might be thought to discourage such desired practices.

A limitation could possibly be implemented in ways that would minimize these problems. A limit on tax credits would probably be most practicable. Tax credits needed to compute final tax liability appropriately (such as the foreign tax credit) could be left unchanged. Credits that provide selective incentives (such as the political contributions credit) could be reduced in their individual computations (for example, the political contributions credit could be cut back by 20 percent by reducing the credit from 50 percent of contributions made to 40 percent and reducing the maximum credit from $100 to $80). Because each of these credits must in any event be individually computed according to some credit rate and some maximum credit amount, changing those parameters would add no complication to the tax forms. Of course, the choice of whether to include any particular tax credit in such a cutback scheme could become the focus of heated political debate, and the equity appeal of the across-the-board approach could be lost.

A limit on itemized deductions would be somewhat more complicated. Deductions needed to measure income appropriately (or considered essential in their present forms for whatever reason) could be excluded from the limit; again, though, such treatment could be criticized as preferential. The deduction for medical expenses already has its own floor of 5 percent of adjusted gross income; that floor could be left in place and separate floors applied to all other itemized deductions. That would, of course, increase the number of computations the taxpayer would have to make. Alternatively, a single floor could be applied to all itemized deductions, replacing the now-separate floor for medical expenses. That would have the possible drawback, however, of allowing a taxpayer with a large deduction for mortgage interest, for example, to deduct his first dollars of medical expenses, while leaving another taxpayer with no such large deduction unable to itemize his medical expenses. Yet another alternative would be to reduce either all or selected itemized deductions by a flat percentage. Such a percentage reduction could be applied to the total amount of deductions, or only to those deductions that exceeded the zero-bracket amount (that is, "excess itemized deductions"). This approach would reduce, but not eliminate, the incentives embodied in the itemized deductions.

If the prevailing sentiment were to treat each itemized deduction or tax credit differently under such a limit approach, the resulting complexity could quickly become overwhelming. A limit on deductions and credits would only be workable if it were kept simple and general in application. Thus, given the likely disputes over the treatment of different deductions and credits, such a limit would likely be viewed as only a temporary revenue-raising measure. If a long-term change in the tax code were desired, effort might more profitably be directed toward ridding the law of obsolete or inefficient provisions on the list of itemizable deductions and credits.

Temporary Income Tax Rate Increase or Surtax. Another incremental across-the-board approach to narrowing the budget gap would be a temporary increase in tax rates. Such a step would likely follow at least the general outline of the 1968 tax surcharge that was imposed to cover the extraordinary expenses associated with the Vietnam War. That surtax was formulated as a flat 10 percent increase in tax liability across the board, though the lowest-income taxpayers were made exempt from the surtax (and a "phase-up" of the surtax liability was necessary to achieve that 10 percent surtax at a higher income level). If imposed today, with no relief for low-income taxpayers, such a surtax would raise more than $30 billion in its first full year (Table X-3).

Whatever form such a surtax took, it would have important macroeconomic policy implications, and its timing would likely be an important criterion for judging it. Such a temporary tax would raise revenues in the short run, but it would presumably be phased out at some pre-established future date. (If such a phase-out were not intended, it would be simpler to impose a permanent rate increase than a surtax.) Such a surtax might be helpful if the economy were embarking on an unsustainable boom; but if imposed in the current slump, it might prolong the slowdown (and then possibly be removed in a subsequent recovery when the economy did not need the stimulus). In contrast, a surtax timed to take effect after the recovery is well under way would not prolong the recession, but it would be more appropriate than a similarly timed permanent rate increase only if future revenues without the surtax would clearly be sufficient to match outlays by some well-defined later date.

Several tax policy issues would be raised by a surtax as well. A surtax would increase marginal tax rates, which might have an adverse effect on economic incentives. Further, depending on the choice of the surtax base, it might or might not be perceived as being fair. A surtax like that applied in 1968, in which all but the lowest-income taxpayers' liabilities were increased by 10 percent, would completely bypass any taxpayer who used various tax shelters or other devices to avoid paying tax. To solve this problem, the base for a surcharge could be some comprehensive measure of income rather than actual tax liabilities, but that would complicate the surtax. It might also make the tax system less progressive overall (apart from the inclusion of a small number of conspicuous tax avoiders), because a surtax based on a progressive income tax liability would be more progressive than a surtax based directly on income. Thus, a family with a $15,000 income and a $1,000 tax liability would pay $100 in a 10 percent surtax based on tax liability, but $150 in a 1 percent surtax based on income; a $150,000 income family with a $30,000 tax liability would pay $3,000 (30 times as much) under the 10 percent surtax on ordinary tax liability, but only $1,500 (10 times as much) under the 1 percent surtax on income.

Thus, though a temporary surtax could be quite simple in outline form, in actual practice it would surely raise many difficult tax policy issues. The appropriateness of the surtax for macroeconomic policy could also be a very contentious issue.

A Corporate Surtax or Minimum Tax. Additional revenues might also be sought from corporations. Businesses have already borne the greater share of the additional taxes as a result of the enactment of TEFRA, but the business tax reductions in ERTA were also very large. Revenue-raising measures for the corporate tax, like those for the individual income tax, ideally should increase revenues more in the future than in the current fiscal year to avoid impeding recovery. Any tax increase should also impose the minimum possible cost in terms of economic distortions and inefficiency.

One approach would be a corporate surtax, possibly to accompany an individual surtax (as was done in 1968). As in the 1968 precedent, such a surtax could be based on tax liability, though in that case firms with no tax liability due only to the use of rapid cost recovery allowances or other tax preferences would avoid the surtax as well as the ordinary tax. At a 10 percent rate, such a surtax would raise about $8 billion in its first full year (Table X-3). An alternative might be to base the surtax on a more comprehensive measure of income that would not allow tax preferences such as accelerated depreciation.

Whatever the precise formulation, the main justification for a corporate surtax is its beneficial effect on the deficit; it is less justifiable on economic and tax policy grounds. An immediate revenue increase through a surtax would impose a drag on the private economy, which is still foundering in recession. Though most formulations would impose a surtax only on firms that are profitable, even those firms have had their profits reduced sharply by the recession. A bigger tax on a smaller profit margin would leave less capital in private hands for financing investment. In terms of tax policy, a surtax that left the current corporate tax base unchanged would not be an improvement.

One approach to broadening the base would be to expand TEFRA's 15 percent cutback of certain corporate tax preferences, including, among others, percentage depletion of coal and iron ore deposits, bad debt reserves, and deferral of tax by Domestic International Sales Corporations (DISCs). That provision of TEFRA is estimated to raise $0.9 billion in 1984 and $1.1 billion in 1988. The rate of the cutback could be increased, or the list of preferences could be expanded. The merits of such a policy depend on the view one holds of the proper role of the tax system in encouraging investment. Some economists argue that the current law's preferences for investment in general (the Accelerated Cost Recovery System, the investment tax credit) and in particular forms (depletion, DISC) provide needed incentives for desirable forms of economic activity. Others counter that such incentives are ineffective in some cases, are easily manipulated and abused, and require higher marginal tax rates on nonpreferred activities (and thus on profits in general). From the former point of view, the current system is preferable; from the latter, a broader-based corporate tax with lower rates would provide the best incentive for the free-market pursuit of profit.

Possible New Taxes

A Value-Added Tax. A value-added tax has often been discussed in recent years as an add-on revenue raiser or as a substitute for one or more taxes now in use. A VAT is, in effect, a sales tax; but rather than being collected in one operation at the retail level, it is collected in parts at every stage of the production process.

The VAT has the advantage that its base can be very broad. Depending on the precise definitions chosen, the VAT base (at 1984 income levels) could be anywhere from $1.6 trillion to $2.6 trillion, and so a 10 percent VAT could raise from $160 billion to $260 billion a year. Such a revenue gain would be so great that it would likely be necessary to reduce other taxes to avoid significantly depressing the economy. To some economists, the revenue potential of the VAT is an important tool for deficit cutting; to others, the revenue yield (plus the hidden nature of the VAT, because it is embedded in market prices) poses a threat that expanding revenues will stimulate spending and swell the public sector.

Advocates of the VAT point out that it is a tax on consumption, rather than on income or wealth. It follows that additional revenues collected by a VAT would not impinge so strongly on saving as revenues collected through an income or wealth tax, and revenues collected through a VAT to replace those now collected through income or wealth taxes should induce net increases in saving. This is because the VAT would make consumption more expensive and saving more profitable after taxes. The greater saving under the VAT would presumably be channeled into productive investment. Just how much additional saving would be stimulated by a complete changeover from income to consumption taxation is subject to much dispute, but the increase would likely be less than 10 percent of personal saving, and less than 2 percent of total private saving.

The fairness of a VAT would probably be controversial. A VAT would increase prices and ultimately be borne by final consumers. This would cause a one-time inflationary shock upon imposition of the tax and would greatly increase the tax burden of lower-income households. This burden could be relieved through an end-of-year refundable income tax credit, but such a credit would not prevent a significant cash flow problem from occurring if low-income households had to pay the substantial VAT all year and then wait until after the year ended to receive their compensating tax credit. Any program to provide a VAT refund continuously over the year would be extremely complicated.

Other ways to reduce the burden on low-income consumers would be to exempt basic goods or necessities from the VAT, or conversely, to apply higher rates to luxury goods. Either course would also lead to complexity, however; the distinction beween necessities and luxuries is inevitably ambiguous. Further, the administration of a tax with varying rates would be extremely difficult. Other nations' experience suggests that a VAT with varying rates is at least as difficult and costly to administer as a corporate income tax.

In fact, a VAT would likely be administratively burdensome, whatever its provisions for low-income relief. The mechanics of a VAT would be entirely different from any tax currently levied by the federal government or any state. 1/ It would therefore require an entirely new administrative apparatus and new forms for filing. For this reason, it is generally assumed that only a VAT of at least 10 percent would justify the administrative load; a low-rate VAT would not be worthwhile. These administrative problems

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1. The one exception is Michigan, which imposes a single business tax that is not unlike a VAT.

could be avoided by enacting a national sales tax instead of a VAT; the ultimate economic effects would be the same, but the sales tax would be both more familiar and easier to administer.

Either a VAT or a national sales tax would also raise questions concerning intergovernmental fiscal relations. Many states raise much of their revenues through sales taxes, and a federal VAT or sales tax would intrude to some extent on that important revenue base of the states and lead to a high total (federal plus state) rate of sales taxation.

An Expenditure or Consumption Tax. A different approach to shifting the tax burden from saving to consumption would be to substitute an expenditure or consumption tax for the present individual income tax. An expenditure tax is essentially an income tax with a deduction for saving. Taxpayers would compute their liabilities by adding up all their income, and then deducting from that total all saving (purchases of stocks and bonds, deposits in bank accounts, business investments, and so on). Their liabilities would be computed on the income that they did not save--that is, their expenditure. (For corporations, the equivalent of the deduction of saving would be immediate expensing, rather than depreciation, of investment.) Many recent income tax initiatives that have exempted from tax various forms of saving have moved in the direction of an expenditure tax; such piecemeal approaches, however, have left the tax code much more complicated and susceptible to abuse than would a true expenditure tax.

While all forms of saving would be deductible without limit under an expenditure tax, the definition of taxable receipts would be much broader than it now is. All receipts of spendable cash would be subject to tax, including the entire proceeds of sales of capital assets (not just the capital gain) and all amounts borrowed. If these amounts were saved or reinvested, however, they would not be taxed. An investor could borrow a sum of money (a taxable receipt) and save it (a deduction for saving) with no tax consequences.

The major argument for the expenditure tax is that it would increase the incentive to save. The savings deduction would also eliminate the income tax's present "double tax" on saving--that is, taxing the money saved when it is earned, and then also taxing the interest that the savings earn. The additional saving would likely result in increased investment. Economists differ on just how much additional saving would be forthcoming under an expenditure tax, but the amount is likely to be similar to that from switching to a VAT--less than 10 percent of personal saving, and less than 2 percent of total private saving. Also, the expenditure tax base would be smaller than that of an equivalent income tax by the amount of saving (about 5 percent of income). That means that the expenditure tax would need somewhat higher tax rates than the income tax, and those higher rates would discourage work to a small degree. An expenditure tax would be less vulnerable to distortion during periods of inflation; because the cost of capital investments would be written off immediately, the mismeasurement of depreciation that can occur with an unindexed income tax would not be a problem.

Like the VAT, the expenditure tax would shift the tax burden from upper-income taxpayers (who find it easiest to save) to lower-income taxpayers (who find it hardest to save). To prevent this redistribution, the tax rate schedule under the expenditure tax would have to be made more steeply graduated than that under the current income tax. The concentration of holdings of wealth would increase unless gifts and bequests were taxed as the consumption of the donor, or a more stringent estate tax or a periodic wealth tax were enacted.

An expenditure tax cannot be viewed as a short-term revenue-raising option. The federal government has had no experience with a consumption tax, and formidable problems could arise in making the transition from an income to a consumption tax. In the long run, however, the expenditure tax could be a realistic option, depending on whether the potential increases in economic growth are judged to outweigh the sizable transition costs.

Base-Broadening with Rate Reductions

A major across-the-board strategy would be to restructure the income tax by combining revenue-raising steps that by themselves would exceed the desired revenue yield, with the excess revenue returned to the taxpayers through across-the-board tax rate cuts. An embodiment of this strategy--a flat rate income tax--has recently drawn considerable attention, and numerous pieces of legislation have been introduced. Under this approach, most or all special tax expenditures or preferences would be repealed, and all of the resulting taxable income (as reduced by some form of personal exemption or standard deduction) would be taxed at a single uniform rate.

The first part of the flat rate tax, the broadening of the tax base through the elimination of tax preferences, might be seen as a more comprehensive extension of TEFRA. That legislation narrowed two individual tax expenditures--the medical expense and casualty loss deductions--and a number of corporate preferences (described earlier). A flat rate tax, or indeed any broad-based revenue-raising strategy, could go further in that direction, up to and including the elimination of all preferences. Broadening the tax base might be desirable on grounds of both equity and efficiency. Proponents point to the fairness of taxing every taxpayer's income, whatever its source, in the same manner. Moreover, economic efficiency is generally reduced by many deductions and credits that alter the private market's relative prices. Each individual base-broadening step might either simplify or complicate the tax system, however. Eliminating itemized deductions would reduce the required number of forms and the amount of record keeping, but taxing heretofore untaxed incomes (such as employer contributions for life and health insurance) would lengthen the forms and complicate tax accounting. Also, many current tax preferences (such as the deductions for mortgage interest and charitable contributions) are deeply embedded in the economy. Repeal would encounter stiff opposition and entail considerable transition costs.

Taxing such a broadened tax base at a flat rate would likely be controversial. On average, the flat tax rate would have the effect of increasing the tax burden for low- and middle-income taxpayers and reducing it for those with higher incomes. The marginal tax rate would be lower for upper-income taxpayers but higher for lower-income taxpayers under a flat tax, so the overall incentive effects would be ambiguous. If the tax base were substantially broadened, however, the current structure of graduated rates could be decreased across the board, improving incentives for all taxpayers and preventing any systematic redistribution of the tax burden.

One approach to a broader-based, flat rate income tax would be to repeal all itemized deductions and the exclusion for long-term capital gains, while increasing the personal exemptions and zero-bracket amounts to protect low-income taxpayers from tax increases. If the personal exemption were raised from $1,000 to $1,500, and the zero-bracket amounts from $2,300 for single persons and $3,400 for couples to $3,000 and $6,000, respectively, the tax rate necessary to match projected calendar year 1984 revenues (about $300 billion) would be about 19 percent. If revenues were to be raised by 5 percent, or about $15 billion, the flat tax rate would have to be increased to about 20 percent. The constraint that the tax rate be flat would require, however, that the impact across income groups not be uniform. Taxpayers with incomes over $100,000 would have their taxes cut by about 21 percent because of the reduction of the upper-bracket tax rates--from a maximum of 50 percent to 20 percent. Taxpayers with incomes of from $5,000 to $10,000 would also have their taxes cut, in this case by 2 percent (from a very small base of only about 3 percent of total revenues) because of the larger exemptions and zero brackets. Those with incomes between those two levels would have to take up the slack, however; their taxes would rise by about 10 percent.

In contrast, a broader-based graduated tax could be designed to achieve any desired distribution, including the replication of that of current law. One legislative proposal was designed to collect 1984 law revenues (before TEFRA was passed) with very nearly the same distribution of liabilities by income group with four marginal tax rates ranging from 14 to 28 percent. 2/ That proposed tax system (or any other designed to achieve revenue and distribution neutrality) could raise 5 percent more revenue from every income group across the board by simply increasing all the marginal rates by about 5 percent (that is, from a range of 14 to 28 percent to one of 15 to 30 percent). At the same time, low-income taxpayers could be excused any additional tax liabilities by increasing the exemptions or the zero-bracket amounts.

The corporate income tax could be treated analogously to the individual income tax. Tax preferences such as the investment tax credit and special provisions for mineral exploration could be repealed, and the corporate tax rate set at a single low level coordinated with the individual income tax rate or rates. (Under a graduated individual income tax, the corporate rate would likely be chosen to equal the highest individual rate.) Alternatively, the corporate and individual income taxes could be integrated to eliminate the double taxation of corporate dividends, which occurs when corporations pay tax on their income, and shareholders pay taxes again on the corporate-source income they receive as dividends. One approach would be to abolish the corporate tax entirely and attribute all corporate income to shareholders for taxation at the individual level. Another would be to retain the corporate tax, but to provide individuals with a tax credit for the corporate tax paid on the dividends they receive. Both of these approaches would eliminate the additional tax on dividends, but both would lose revenue, thereby requiring higher tax rates (especially for upper-income taxpayers, if it were desirable to recover the lost revenue from those whose taxes were cut most by integration), and would also complicate the tax system.

A broad-based low-rate income tax is in principle an attractive way to increase tax revenues while minimizing the efficiency cost to the economy. In the final analysis, however, the amount of tax rate reduction possible is directly related to the degree by which the tax base is broadened. Numerous politically popular tax preferences would have to be cut back or eliminated to make the lower-rate tax work, and if a net revenue gain were required, not all of the gains from base broadening could be devoted to rate reduction.

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2. During the 97th Congress, the plan was introduced in the Senate by Senator Bill Bradley as S. 2817, and in the House of Representatives by Representative Richard Gephardt as H.R. 6944.

Table X-5 lists a number of base-broadening possibilities for both the individual and the corporate income taxes. For the individual income tax, the revenue base would have to be broadened by about $15 billion to finance a one-percentage-point reduction in all marginal tax rates. This amount could be achieved, for example, by limiting the deductibility of consumer interest payments, eliminating the deduction for state and local sales taxes, and taxing the accrued interest on life insurance reserves. A one-percentage-point reduction in the top corporate income tax rate would require about $1.5 billion from base broadening. This could be achieved, for example, by repealing the expensing of intangible oil and gas drilling costs or by increasing from 15 to 20 years the period over which buildings must be depreciated.

TARGETED REDUCTION STRATEGIES

Instead of adopting an across-the-board strategy of imposing relatively small tax increases on a wide range of taxpayers and economic activities, the Congress could pursue a more targeted strategy that would have narrower effects. Taxes could be increased for particular groups of individuals or types of activities that are currently thought to be undertaxed or better able than others to bear the burden of tax increases. The base-broadening approach discussed above includes many possible changes of this kind. This section covers other possibilities, such as increased energy taxes, excise taxes, user charges, and Social Security payroll taxes, which could raise issues different from those arising from income tax changes. This section also includes a brief discussion of some options for making direct trade-offs between reductions in spending programs and closely related tax expenditures.

Energy Taxes

The United States continues to depend on foreign oil for approximately 33 percent of its oil consumption and more than 10 percent of total energy consumption. This dependence creates a series of risks for the U.S. economy, the most important of which is the danger that these supplies will be interrupted and the U.S. economy severely dislocated as a consequence. Reducing U.S. dependence on foreign petroleum can relieve this vulnerability, decrease the outflow of dollars that pay for oil, and remove constraints on the conduct of U.S. foreign policy.

Despite these compelling reasons to encourage energy conservation and replacement of oil with other energy sources, the recent slowdown in oil prices has diminished the incentives to do either. At the same time, the

TABLE X-5. ESTIMATED REVENUE GAINS FROM INCOME TAX BASE-BROADENING OPTIONS (In billions of dollars)

	Individual Income Tax						Corporate Income Tax					
Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Phase Out Domestic International Sales Corporations	--	--	--	--	--	--	*	0.2	0.3	0.5	0.6	1.7
Reduce Credit for Incremental Research Expenditures	*	*	*	*	*	0.1	0.3	0.4	0.2	*	*	0.9
Repeal Percentage Depletion Allowance for Oil and Gas	0.6	1.3	1.4	1.5	1.6	6.4	0.3	0.4	0.5	0.5	0.6	2.3
Repeal Expensing of Intangible Drilling Costs for Oil and Gas	0.3	0.9	1.0	1.1	1.1	4.5	2.3	3.6	3.2	3.0	2.8	14.8
Repeal Residential Energy Tax Credits	0.1	0.9	1.0	0.1	*	2.0	--	--	--	--	--	--
Repeal Business Energy Tax Incentives	*	*	*	*	*	0.2	0.3	0.5	0.4	0.5	0.5	2.1
Eliminate Capital Gains Treatment of Timber	--	0.2	0.2	0.2	0.2	0.8	0.2	0.4	0.5	0.6	0.6	2.3
Eliminate Tax Exemption for Pollution Control Bonds	*	*	0.1	0.1	0.2	0.4	*	0.1	0.2	0.2	0.3	0.8
Limit Nonbusiness, Non-Investment Interest Deductions to $10,000	0.6	1.8	2.0	2.2	2.4	9.0	--	--	--	--	--	--
Tax 10 Percent of the Capital Gain on Home Sales	--	0.8	1.0	1.2	1.4	4.4	--	--	--	--	--	--
Lengthen the Building Depreciation Period to 20 Years	0.1	0.3	0.7	1.1	1.5	3.6	0.4	1.5	3.0	4.6	6.2	15.8
Tax the Accrued Interest on Life Insurance Reserves	2.1	5.8	6.6	7.6	8.7	30.8	--	--	--	--	--	--
Repeal Net Interest Exclusion	--	1.1	3.0	3.4	3.7	11.2	--	--	--	--	--	--
Eliminate Tax Exemption for Small Issue Industrial Revenue Bonds	*	*	0.1	0.2	0.3	0.7	*	0.2	0.5	1.0	1.2	3.0
Limit the Business Deduction for Entertainment to 50 Percent of Amount Spent	0.2	0.4	0.5	0.5	0.6	2.1	0.4	0.7	0.8	0.8	0.9	3.6
Require Full Basis Adjustment for the Investment Tax Credit	--	0.2	0.4	0.5	0.8	1.9	0.3	1.0	2.0	3.0	4.1	10.3
Eliminate the Accumulated Earnings Allowance for Personal Service Corporations	0.2	0.7	0.7	0.8	0.8	3.3	-0.1	-0.3	-0.3	-0.3	-0.3	-1.3
Eliminate Tax Credits for Rehabilitating Older Buildings	0.4	0.6	0.8	0.8	0.9	3.5	0.4	0.6	0.6	0.8	0.9	3.3

(Continued)

* Less than $50 million.

TABLE X-5. (Continued)

	Individual Income Tax						Corporate Income Tax					
	1984	1985	1986	1987	1988	Cumulative Five-Year Increase	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Repeal Extra Parental Personal Exemption for Students	0.3	0.8	0.8	0.9	0.9	3.7	--	--	--	--	--	--
Tax Nonstatutory Fringe Benefits	0.6	1.2	1.3	1.5	1.8	6.4	--	--	--	--	--	--
Limit Charitable Deduction for Non-itemizers to $100	--	0.2	1.9	3.6	--	5.7	--	--	--	--	--	--
Repeal the Tax Credit for Employee Stock Ownership Plans	--	--	--	--	--	--	0.7	1.7	2.1	2.3	1.1	7.8
Tax Some Employer-Paid Health Insurance												
Income Tax	2.7	4.9	6.0	7.2	8.7	29.6	--	--	--	--	--	--
Payroll Tax	--	--	--	--	--	--	0.8	1.5	1.9	2.2	2.6	9.1
Eliminate Tax Exemption for Private Hospital Bonds	*	0.1	0.2	0.3	0.4	1.0	0.1	0.2	0.4	0.6	0.8	2.0
Eliminate Extra Tax Exemptions for the Elderly or the Blind	1.0	2.5	2.6	2.8	2.9	11.8	--	--	--	--	--	--
Tax 50% of OASDI Benefits for Families with Total Incomes Above $12,000/$18,000 a/	1.7	5.8	6.6	7.4	8.2	29.7	--	--	--	--	--	--
Tax 40 Percent of Railroad Retirement Benefits b/	0.5	0.7	0.8	0.8	0.8	3.6	--	--	--	--	--	--
Tax Workers' Compensation Benefits b/	1.5	2.4	2.8	3.2	3.6	13.5	--	--	--	--	--	--
Tax All of Unemployment Insurance Benefits b/	*	1.7	1.6	1.7	1.6	6.5	--	--	--	--	--	--
Eliminate Income Averaging	3.5	3.8	4.2	4.5	4.9	20.9	--	--	--	--	--	--
Freeze Estate and Gift Credit at Exemption Equivalent of $275,000	--	0.5	1.1	1.8	2.6	6.1	--	--	--	--	--	--
Tax Veterans' Compensation b/	1.1	1.8	1.8	1.8	1.8	8.4	--	--	--	--	--	--
Eliminate Deductibility of State and Local Sales Taxes	0.9	5.8	6.4	7.0	7.8	27.9	--	--	--	--	--	--
Improve Taxpayer Compliance c/	1.2	2.0	3.5	4.0	4.4	15.1	0.0	0.2	0.7	0.7	0.7	2.3

SOURCE: Joint Committee on Taxation and Congressional Budget Office.

NOTE: Unless indicated otherwise, explanations and arguments pertaining to these options are detailed in Appendix A. All revenue gain estimates assume January 1, 1984 effective dates. Totals may not add because of rounding.

a. Discussed in detail in Chapter III.

b. Discussed in detail in Chapter V.

c. This amount is gross of outlay offset.

current glut in the oil market increases the likelihood that a tax on oil imports would be absorbed in part by producers. These energy policy considerations, combined with the need to raise large amounts of revenue, have focused attention on energy tax increases as a major option for reducing future deficits.

Imposing energy taxes, however, involves a basic trade-off between two policy objectives--the goal of sending correct signals to the energy market, and the goal of imposing new taxes at minimum economic cost. An oil import fee, for example, sends correct signals to the energy market by raising the price that consumers pay for imported oil. Such a price increase, however, would lead to parallel increases in the prices of domestic oil, natural gas, and some coal. While these parallel price increases are desirable from the standpoint of energy policy (since they create incentives to supply more of these substitutes for foreign oil), they also increase the energy costs of all users, even those who do not use foreign oil. One way to minimize this cost burden while raising the same amount of revenue would be to tax all energy sources directly at a lower rate. This would reduce the cost burden on any particular user by spreading the burden more thinly, but it would also discourage the production of these potential substitutes for foreign oil. Thus, minimizing the burden placed on the economy through an energy tax would require compromising the drive to substitute for foreign oil. Conservation would still be encouraged as a result of the higher prices, and this by itself would help to reduce reliance on imported oil, but the incentive to substitute domestic production would be dampened. Table X-6 displays the estimated revenue increases from the energy taxes considered in this section.

Oil Import Fee. An oil import fee would raise about $2 billion a year in revenue for each $1 per barrel. About one-quarter of that amount would come from higher windfall profit taxes, since the import fee would allow the price of all domestically produced oil to increase, thereby increasing the profits of domestic oil producers. An oil import fee could also add to inflation, however, thereby increasing federal outlays for inflation-sensitive programs such as Social Security and Food Stamps. These increased outlays could offset about 30 percent of the increases in revenues. If tight monetary policy limited price increases, both revenues and offsetting increases in outlays could be reduced.

A fee on oil imports would heighten conservation incentives by pushing up the price of all imported and domestically produced oil, and the higher price for domestic oil would increase incentives for domestic production. Both effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased as U.S. energy sources become depleted. At the same time, a fee on imported oil would increase

TABLE X-6. ESTIMATED REVENUE GAINS FROM ENERGY TAXES
(In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Impose Oil Import Fee ($2 per barrel)	3.1	4.4	4.3	4.3	4.3	20.4
Impose Broad-Based Tax on Domestic Energy (5 percent of value)	11.3	17.2	18.5	20.0	21.6	88.6
Impose Tax on Domestic and Imported Oil ($2 per barrel)	5.9	8.5	8.5	8.5	8.5	39.9
Impose Excise Tax on Natural Gas (30 cents per 1,000 cubic feet)	2.1	3.0	3.0	3.0	3.0	14.1
Increase Gasoline Excise Tax (5 cents per gallon)	2.9	4.1	4.1	4.2	4.2	19.5

SOURCE: CBO and the Joint Committee on Taxation.

inflation and reduce employment somewhat in the United States. With the rate of increase in world oil prices now leveling off, the effects of an import fee on inflation could be easier to absorb than they would have been in earlier years, when rapid increases in world oil prices were themselves imposing substantial dislocation and transition costs.

At least initially, an oil import fee would have its heaviest impact in certain areas of the country, such as the Northeast, where homeowners depend heavily on imported fuel oil to heat their homes. As the effects of the oil import fee worked their way through the economy, however, other energy prices, such as those for coal and natural gas, would gradually rise to the levels set by imported oil prices, thereby spreading the effects of the oil import fee more evenly to all parts of the country and all energy users.

It should be noted that an oil import fee provides a subsidy to all the energy sources that compete with foreign oil in energy markets, since it allows their prices to increase. Thus, if an oil import fee is imposed, the Congress might wish to reconsider some existing, more explicit subsidies to energy producers and users. These might include the special tax treatment for the oil and gas industry, research and development subsidies for alternative energy sources, and tax credits for installing energy conservation or substitution investments. Reducing or eliminating these tax subsidies could provide a stable source of long-term revenue to help reduce future deficits. Some options of this kind are listed in Table X-5.

Broad-Based Tax on Imported and Domestic Energy. A broad-based tax on all energy--both domestically produced and imported--could raise substantial amounts of revenue (see Table X-6). A five-percent-of-value tax on all U.S. energy consumption, including coal, petroleum, natural gas, hydroelectric, and nuclear power, would raise about $15 to $20 billion a year in revenues. Limiting the tax to domestic and imported oil would still raise significant revenue. A $2-per-barrel tax on all oil would raise about $8 to $9 billion per year. A national energy tax could be based on units produced (such as barrels of oil, tons of coal, cubic feet of gas), on the value or price of the energy produced (ad valorem tax), or on the heat content--in British thermal units--of the fuel (Btu tax). It could be collected at the source of initial production, or at the wholesale level if that was administratively more convenient. If the tax was uniformly based on Btu content it would alter the relative prices of different energy sources; oil is more expensive per Btu than is natural gas, and natural gas is more expensive than coal. Therefore, a uniform Btu tax would raise the price of coal most and oil least in percentage terms.

A national energy tax would raise the price to consumers of all domestically produced energy, just as an oil import fee would. But all of the resulting energy cost increase would be captured in taxes by the federal government. This contrasts with an oil import fee, which allows domestic energy producers to raise their prices in tandem, but with only part of the increase captured through windfall profit taxes. The effects of the price increase would also be spread more evenly across different parts of the country and different types of energy consumers than would the initial effects of an oil import fee.

Since the domestic price of energy continues to be set by the world oil price, a national energy tax would tend to be absorbed in part by energy producers, who would be unable to pass on the full cost of the tax to consumers. Though this would lessen the impact on consumers, it would also lessen incentives for domestic energy production.

Windfall or Excise Tax on Decontrolled Natural Gas. Price controls on a large share of domestic natural gas production are due to be lifted on January 1, 1985, under the terms of the Natural Gas Policy Act of 1978 (NGPA). Not all gas will be decontrolled; an estimated 60 to 75 percent of natural gas will remain regulated and still subject to price controls in 1985.

Economists generally agree that the price controls under NGPA have led to an inefficient allocation of natural gas. In addition, because of "take-or-pay" contracts negotiated by gas pipeline companies (which require them to pay gas producers for high-priced gas whether or not there is consumer demand for it), the market for natural gas is not currently functioning efficiently. Indeed, there have been relatively large price increases during a period of slack gas demand, and low-cost natural gas has been held off the market. Thus, even though decontrol of all natural gas may make sense for energy policy in the long term, pressures to impose further price controls are now strong. To a great extent, however, the present distortions in the gas market are exacerbated by the drop in demand caused by the recession. Once economic growth resumes and demand for gas rises, the high fixed costs of gas purchased under take-or-pay contracts will be spread out over a larger volume of gas, easing the upward pressure on prices. Growth in demand will also draw into the market more relatively low-cost gas, further reducing cost pressures.

Decontrol of all natural gas on January 1, 1984 could give producers large profits, which the Congress may want to tax similarly to the present windfall profit tax on oil. Depending on how it was structured, such a tax could raise as much as $2 to $5 billion in revenue in 1984, although already-high gas prices and the current soft market for natural gas could limit both the price and profit increases from decontrol. If the tax was limited only to the profits from the acceleration of decontrol before the scheduled date of January 1, 1985, revenues would drop sharply after the first year. Such a tax would thus not be consistent with the economic and budgetary goals outlined earlier, which emphasize minimizing tax increases in 1983 and 1984 as the economy is recovering while building in stable sources of revenue for the longer term.

An alternative that would raise revenues on a long-term basis would be to impose a simple excise tax unrelated to any windfall profits from decontrol. An excise tax of 30 cents per 1,000 cubic feet, for example, would raise about $3 billion a year. Such a tax would be similar to the broad-based tax on energy production discussed above, but it would apply only to natural gas. An excise tax limited to natural gas would provide an incentive for gas users to switch to oil, coal (of which the United States has abundant reserves), or other substitutes, which might or might not be consistent with energy and other policy goals. A shift to oil, for example, could increase dependence on imports, while a switch to coal would lessen dependence on imports but could impose environmental costs. A selective excise tax on natural gas would have the side effect of burdening households already hard hit by increases in their home heating bills. If an excise tax on natural gas was part of a broad-based tax on all energy, it would not distort consumers' choices among fuels.

Gasoline Excise Tax. The federal tax on gasoline was increased by 5 cents per gallon in January 1983 as a result of the Surface Transportation Assistance Act of 1982; it had been 4 cents per gallon since 1959. This tax increase was not designed to reduce the deficit; the amounts raised are to be spent on highways, bridges, and mass transit. In addition to the current federal tax of 9 cents per gallon, state governments impose gasoline taxes ranging from 5 to 14 cents per gallon. Gasoline taxes were increased in 26 states in 1981 and 1982, as a result of either legislation or formulas in the law.

If the Congress wanted to raise additional revenues from this source to reduce the deficit, an increase in the federal tax beyond the amount enacted last year could be considered. Each 1 cent increase in excise tax on gasoline and diesel fuel raises about $1.1 billion in excise tax revenues. There would be offsetting reductions in individual and corporate income taxes, however, so the net reduction in the deficit would be about 25 percent less than that.

Since the average national price of gasoline has dropped from a peak of about $1.39 a gallon in March 1981 to about $1.20 now, raising the tax on gasoline by more than 5 cents per gallon would not put the total cost above what consumers have recently experienced. The 4-cents-per-gallon tax imposed in 1959 would be 13 cents now if it had been increased in line with other prices, and 16 cents if it had kept pace with gasoline price increases.

Beyond raising revenue, an excise tax on gasoline would reduce gasoline consumption and thus somewhat lessen U.S. dependence on foreign oil. Each 1 cent increase in the gasoline excise tax is estimated to reduce consumption by about 0.3 percent in the long run. Some income groups would bear disproportionately heavy burdens from an increase in gasoline excise taxes. Lower-income families pay fewer dollars but higher percentages of their incomes for gasoline than do families with higher incomes. The 20 percent of families with the lowest incomes spend an estimated 7 percent of their incomes on gasoline, while those in the top 20 percent only spend an estimated 3 percent.

Gasoline consumption also varies by region and population density, with the heaviest use in the South and West and in rural areas, and the least use in the Northeast and in urban areas. Because of this pattern, combining an increase in gasoline excise taxes with a tariff on imported oil, which would have its heaviest initial impact in the Northeast, would have a more balanced geographic impact than implementing either policy by itself.

Further increases in the federal gasoline tax could make it more difficult for states to raise their gasoline taxes. The new Surface Transportation Assistance Act requires state matching funds for federally assisted projects, and states have other highway financing needs as well. Some consideration should be given, therefore, to the total potential burden that can be placed on this revenue source.

Excise Taxes

The major federal excise taxes, other than those levied on gasoline and windfall oil profits, are on alcohol, tobacco, and telephone use. Several other excise taxes support the Airport and Airway Trust Fund. Although TEFRA made no changes in the excise taxes on alcohol, it did temporarily double the excise tax on cigarettes. In addition, it temporarily tripled the excise tax on telephone use, and substantially increased the taxes that finance the Airport and Airway Trust Fund.

Additional revenues could be raised by extending the temporary increases in the tobacco and telephone excise taxes and increasing the excise taxes on alcohol. Excise taxes could also be imposed on various "luxuries," provided definitions could be agreed on. Table X-7 displays the estimated added revenues from these options.

Cigarettes. TEFRA increased the 8-cents-per-pack tax on cigarettes to 16-cents-per-pack for the period from January 1, 1983, through September 30, 1985; this will raise net federal revenues by about $1.7 billion a year, taking into account the effect of the excise in narrowing the income tax base. Extending the higher taxes past the 1985 expiration date now scheduled would continue the flow of additional revenues from this source at about that same level. The 16-cents-per-pack tax represents about 18 percent of the current cost per pack, still less than the 37 percent of the cost per pack that 8 cents represented back in 1951, when cigarette excise taxes were last raised.

Another option would be to index the unit tax on cigarettes to the rate of change of the Consumer Price Index. Such indexing would raise at least an additional $0.4 billion each fiscal year, and the cigarette excise tax would be maintained at about 18 percent of the current per-pack cost of cigarettes.

TABLE X-7. ESTIMATED NET REVENUE GAINS FROM EXCISE TAX INCREASES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Extend Doubling of Cigarette Excise Tax Beyond 1985 a/	---	---	1.7	1.7	1.7	5.1
Continue 3 Percent Excise Tax on Telephone Service Beyond 1985 b/	---	---	1.3	2.3	2.7	6.3
Double Excise Taxes on Alcohol c/	2.5	4.0	4.0	4.0	4.1	18.6
Impose Excise Tax on Luxuries c/ d/	0.2	0.3	0.4	0.4	0.4	1.7

SOURCE: Congressional Budget Office and the Joint Committee on Taxation.

NOTE: The revenue effects are net of income tax offsets. Excise tax increases lower income tax revenues because they can be deductible business expenses and because, unless monetary policy is fully accommodating, they lower taxable incomes throughout the economy. Taking both of these effects into account, and assuming an economy-wide marginal tax rate of 25 percent, results in a net revenue effect that is 75 percent of the gross effect.

a. The doubling of the cigarette excise tax expires October 1, 1985, under current law. The extension beyond 1985 assumes no break in tax collections.

b. The telephone excise terminates December 31, 1985, under current law.

c. The effective date is January 1, 1984.

d. The base of luxury excise taxes is defined as the price of cars, boats, and yachts in excess of $20,000 and jewelry in excess of $1,000.

Telephones. Under pre-TEFRA law, the excise tax on telephone service was set at 1 percent through the end of calendar year 1984, when it was scheduled to expire. TEFRA increased it to 3 percent for calendar years 1983-1985, with termination now scheduled for December 31, 1985. The increase is estimated to raise revenues by $1.1 billion in fiscal year 1984 and $1.6 billion in 1985 (taking into account the automatic offsets in income taxes). Continuing the 3 percent tax beyond 1985 would, over the long term, raise about $2 to 3 billion a year in net additional revenues.

Alcohol. The tax of $10.50 per gallon on distilled spirits has not been changed since 1951. Doubling it, to $21.00, would raise about $2.7 billion a year (after income tax offsets), putting the tax at about 45 percent of the average product price--slightly more than the 43 percent that the $10.50 tax represented in 1951. Indexing the distilled spirits tax to the CPI would raise at least an additional $0.5 billion in revenues each fiscal year.

Beer and wine--nondistilled beverages--are subject to other excise taxes. At present, the taxes on beer and wine together raise about $1.9 billion each fiscal year. The excise taxes on beer and wine have not been raised since 1951. Doubling the beer and wine excise taxes would raise about $1.3 billion a year in net new revenues. An additional $0.2 billion could be raised each year by indexing the excise taxes on beer and wine to the CPI. Coordination of the taxes on different alcoholic beverages, either in terms of the percentage of retail cost or the tax per unit of alcohol, might be desirable; under present law, beer and wine are both taxed significantly more lightly than distilled spirits, with wine receiving the most favorable treatment.

Luxuries. Excise taxes on "luxuries"--defined to include fur clothing, jewelry, luggage, and toilet preparations--were enacted during World War II and repealed in 1965. A reinstituted excise tax on these items, set at 10 percent, would raise about $1.7 billion a year in net federal revenues, with about $0.7 billion each coming from jewelry and toilet goods, and the rest from furs and luggage. If the tax were limited to the amount above some high threshhold--for instance, 10 percent of the retail price over $1,000 for jewelry and furs--the revenue gain would be much smaller, probably not much more than $100 million a year.

The definition of "luxuries" could be broadened to include automobiles and recreational boats. A luxury tax on expensive cars and boats would raise only small amounts if the tax was limited to the amount of the purchase price over some threshold. A tax of 10 percent on that part of the price of cars and boats that exceeded $20,000 would only raise about $200 million a year, for example. An undesirable "notch" effect would result if no tax was imposed on those costing less than $20,000, for example, while a full 10 percent was imposed on those costing $20,000 or more. Taxing 10 percent of the full price of expensive automobiles and boats would raise about $1 billion a year.

User Fees

Revenues could also be raised by imposing fees on some federally provided services that are now available free of charge or at less than their true market cost. In effect, the government is transferring income and resources to the beneficiaries of these services if it does not impose charges equal to their costs. User fees could require that the cost of services be paid by those who use them. Chapter IX contains a discussion of a large number of user fee options. Those that take the form of revenues are shown in Table X-8.

TABLE X-8. ESTIMATED REVENUE GAINS FROM USER CHARGES CLASSIFIED AS REVENUES (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Highways	1.1	1.1	1.1	1.1	1.1	5.4
Airways	1.1	1.1	1.1	1.1	1.1	5.4
Inland Waterways	0.7	0.7	0.8	0.8	0.8	3.7
Strategic Petroleum Reserve	0.3	0.3	0.3	0.3	0.3	1.5

SOURCE: Congressional Budget Office.

Those user fees classified in the federal budget as revenues are mainly those that result from government imposition of a mandatory tax on some activity. Others are classified as offsetting receipts, and these show up as reductions in the outlay programs under which they fall. Offsetting receipts are collections that occur when the government acts like a private business and sells some good or service for which it charges a fee. The fees collected offset the budgetary outlays associated with the federal activity.

Social Security Payroll Taxes

The National Commission on Social Security Reform has recommended a series of measures that would add an estimated $116 billion to the Social Security trust funds over the 1984-1988 period. About $45 billion of that amount would be in the form of higher Social Security payroll tax collections. The net effect on 1984-1988 federal revenues would be less than that, however, since individual income taxes would be reduced by about $11 billion because of the proposed credit against income taxes for 1984 payroll tax increases, and the proposed deductibility of half of payroll taxes for the self-employed. The proposed taxation of half of Social Security benefits for single people with incomes over $20,000 and married couples with incomes over $25,000 would raise income tax collections by an estimated $22 billion over the period, and this amount would be transferred to the Social Security trust funds. As shown in Table X-9, the net increase in revenues from all the Commission's proposals is estimated to be about $57 billion from 1984-1988. The options recommended by the Commission, as well as several other options, are discussed in detail in Chapter III.

Tax Entitlement Benefits as an Alternative or Supplement to Direct Benefit Cuts

Many of the options outlined in Chapters III and V would entail cutbacks in entitlement programs that pay benefits directly to individuals, such as Social Security, Railroad Retirement, workers' compensation, veterans' disability compensation, unemployment compensation, and Aid to Families with Dependent Children. One way of cutting back on benefit payments is to reduce payments to recipients whose incomes are relatively high and who thus have less need for income support. This can be done either directly by tightening program eligibility standards or indirectly by subjecting some or all of the benefits to the individual income tax. An example under current law is unemployment compensation which, when received by persons with incomes of more than $18,000 a year ($12,000 for single people), is subject to tax. This affects largely those who are unemployed for only a portion of the year or who have income from other sources. Most other benefits, however, are tax free.

This same approach could be followed for other benefit payments to individuals. A number of possibilities are discussed in detail in Chapters III

TABLE X-9. REVENUE EFFECTS OF NATIONAL COMMISSION ON SOCIAL SECURITY RECOMMENDATIONS, PRELIMINARY ESTIMATES, FISCAL YEARS 1984-1988, (In billions of dollars)

Recommendation, By Tax Source Affected	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Social Insurance Taxes and Contributions a/						
Coverage of Nonprofit and New Federal Workers b/	1	2	3	3	4	13
Revised Tax Rate Schedule	6	2	--	--	10	19
Higher Tax Rate for Self-Employed b/	1	3	3	3	4	14
Individual Income Taxes						
Taxation of Benefits for Higher-Income Persons c/	1	4	5	6	6	22
Income Tax Deduction for Half of Self-Employment Tax	-1	-2	-1	-2	-2	-7
Income Tax Credit in 1984 for Payroll Tax Increase	--	-4	--	--	--	-4
Total	9	6	9	10	23	57

SOURCE: Congressional Budget Office and the Joint Committee on Taxation.

NOTE: Detail may not add to totals due to rounding.

a. Only OASDI revenues.

b. Calculated with revised tax rate schedule. The estimate includes ban on withdrawal of state and local workers, but ignores any revenue loss from reduced federal civilian employee retirement contributions.

c. These income tax revenues are to be transferred to the Social Security trust funds.

and V. Examples of the revenue gains that could be obtained from taxing entitlement benefits are shown in Table X-10.

TABLE X-10. ESTIMATED REVENUE GAINS FROM TAXING SELECTED ENTITLEMENT BENEFITS (In billions of dollars)

Options	1984	1985	1986	1987	1988	Cumulative Five-Year Increase
Tax Half of Retirement Benefits for Social Security Recipients with Incomes Above $12,000/$18,000	1.7	5.8	6.6	7.4	8.2	29.7
Tax 40 Percent of Railroad Retirement Benefits	0.5	0.7	0.8	0.8	0.8	3.6
Tax Workers' Compensation Benefits	1.5	2.4	2.8	3.2	3.6	13.5
Tax All Unemployment Insurance Benefits	a/	1.7	1.6	1.7	1.6	6.6
Tax Veterans' Disability Compensation	1.1	1.8	1.8	1.8	1.8	8.4

SOURCE: Congressional Budget Office and the Joint Committee on Taxation.

a. Less than $50 million.

CONCLUDING COMMENTS

The Congress is faced simultaneously with unprecedentedly large and persistent future budget deficits and the worst recession since World War II.

Raising revenues is an obvious course to help reduce future deficits, but timing is a critically sensitive issue. Revenue increases could make the current recession worse if they took effect before recovery was fully under way. This chapter therefore emphasizes revenue-raising options that could be put into effect gradually, and that would provide a stable and reliable source of revenue well into the future.

Tax increases inevitably inhibit economic activity to some extent, no matter when they are put into effect. The chapter therefore focuses on tax increase options that would minimize adverse effects on the incentives to work, save, and invest--such as measures that would tend to equalize the rate of tax on different investments, or make possible reductions in marginal tax rates.

Measured against these criteria, tax increases designed explicitly to achieve short-term effects--such as income tax surcharges of various kinds--do not stack up well. If they were to take effect soon they would raise taxes when an increase might be harmful, while doing nothing to help the longer-term deficit problem. Many forms of surtaxes also increase marginal tax rates, which could further inhibit economic activity.

Limits on using special tax deductions, exclusions, or exemptions--such as the existing individual and corporate minimum taxes--could well serve to even out somewhat the tax treatment of different industries and economic activities. The greater neutrality of saving and investment incentives could improve the allocation of resources, and thus economic growth. Broadening this minimum tax approach by bringing in additional forms of untaxed or lightly taxed income could be a further move toward neutrality.

Major base-broadening and rate-reduction initiatives for both the individual and the corporate income taxes are most consistent with the economic criteria described above. Reductions in marginal rates can increase work, saving, and investment incentives; broadening the tax base by subjecting more forms of income to regular taxation can encourage a more efficient and productive flow of investment resources. In addition, the need to phase in most base-broadening initiatives to avoid unfairness and dislocation ensures that the resulting tax increases would not occur during the current recession, while the structural nature of the changes required makes it likely that they would remain in place well into the future, providing a reliable flow of long-term revenues.

The various energy tax options do not increase marginal tax rates on work, saving, or investment, but taxes limited to certain forms of energy could distort investment away from those types of energy and toward others. Energy policy may justify selective encouragement and discouragement of different types of energy production or use, however. Energy policy considerations might suggest that coal production and use be encouraged, for example, since the United States has ample and secure domestic supplies of coal. Some energy tax options are explicitly short term, such as a windfall profit tax on natural gas. Such a tax could harm short-term economic prospects while doing very little to narrow long-term deficits.

Excise taxes of various kinds also do not increase marginal income tax rates, but they also can distort consumers' decisions. Again, however, other considerations may make these kinds of incentives and disincentives desirable from some perspectives. Excise taxes on alcohol and cigarettes, for example, may be viewed favorably as tending to discourage activities that impose costs on society.

User charges, judged on economic and budgetary grounds, stack up well. They encourage efficient allocation of resources, and they can usually be designed to remain in place for long periods.

Social Security payroll tax increases, generally evaluated in the context of the needs of the Social Security system, can also be a major source of federal revenue. Nonetheless, depending on their form, they could increase marginal tax rates on labor and thus discourage work effort, and increase the cost of labor to employers and thus discourage hiring. They can also add to inflation. Most proposals are explicitly long-term measures, and thus such increases could assist with the long-term deficit problem.

Taxing benefit payments to individuals under the income tax can be an effective way of directing scarce government resources to persons most in need. Taxing benefits might also be administratively easier than implementing income-dependent eligibility rules, unless a reliable and accepted system for checking beneficiaries' incomes and limiting benefits on a regular basis is already in place. Taxing benefit payments represents the kind of structural change that is likely to remain in place over the long term, producing a steady flow of revenues.

APPENDIXES

APPENDIX A. INCOME TAX BASE-BROADENING OPTIONS

This Appendix presents 29 options to increase revenues over the 1984-1988 period by broadening the base of either the individual or the corporate income tax. Four additional base-broadening options, dealing with the taxation of transfer payments, are examined in Chapter V, which covers other benefit programs. One other, the taxation of part of Social Security benefit payments, is considered in Chapter III, along with other Social Security options. Other major tax increase options, including repeal of indexing, income tax surtaxes, energy taxes, and excise taxes are discussed in Chapter X. Chapter IX covers user charges and Chapter III Social Security payroll tax increase options; these discussions are summarized briefly in Chapter X. All the revenue increases are relative to the CBO baseline, which projects what revenues are likely to be under current law, assuming that the economy performs as presented in a companion volume to this report, The Outlook For Economic Recovery. The actual baseline used in this analysis is summarized in another companion volume, Baseline Budget Projections For Fiscal Years 1984-1988.

As with the deficit reduction options, the individual tax increase options cannot be added to an aggregate total, because there are often complex interactions and offsets among the options. In addition, the estimates do not include any indirect effects, nor do they assume any major behavioral changes resulting from the tax changes. Unless specified otherwise, the estimates assume that the proposals under discussion take effect on January 1, 1984. The items discussed in this Appendix are simply illustrative examples. The inclusion of an item, or omission of one, does not imply a recommendation by CBO. The options in this appendix are ordered according to the budget function they would affect.

PHASE OUT DOMESTIC INTERNATIONAL SALES CORPORATIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	a	0.2	0.3	0.5	0.6	1.7

a. Less than $50 million.

Domestic International Sales Corporations (DISCs) are special corporations established as conduits for export sales. As such, they are "paper corporations" with no employees and no actual operations that allow their parent corporations to defer the payment of income taxes on a portion of their profits. In the case of most DISCs, 50 percent of the parent corporation's export-related profits may be allocated to the DISC. About 42 percent of the tax liability on these profits above a base level can be deferred indefinitely, amounting to about a 21 percent tax deferral for the parent corporation (0.5 x 0.42 = 0.21). The subsidy is enhanced by use of special intercompany pricing rules governing the allocation of income between the DISC and its suppliers.

The principal objective of the 1971 legislation establishing DISCs was to increase exports as a way of improving the U.S. balance of trade and increasing domestic employment. They were intended to help offset existing tax incentives--both domestic and foreign--that encourage U.S. companies selling products abroad to establish plants abroad rather than to produce goods at home. Some evidence suggests that the level of exports increased somewhat during the 1973-1979 period because of the DISC provisions. Most of this increase took the form of one-time expansions of exports during the first few years of each DISC's operation. Some of the increase in exports attributable to DISCs comes at the expense of non-DISC exporting companies, however.

TEFRA reduced several corporate tax preferences, including those applying to DISCs. The act provided for a 15 percent cut in the DISC subsidy by increasing from 50 percent to 57.5 percent the share of DISC profits that must be distributed to shareholders as taxable dividends. Additional revenues could be gained by phasing out DISCs altogether. One method of doing so would be to phase out tax benefits for DISCs at an annual rate of 25 percent over a four-year period, beginning January 1, 1984. This would increase federal revenues by about $1.7 billion over the

1984-1988 period. Deferral of the accumulated tax liability on past earnings of DISCs could continue as long as the earnings remained invested in export-related assets, or some or all of the accumulated tax liability could be recaptured over a specified period. If included, recapture of accumulated tax liability on past earnings would increase the revenue gained from repeal of the DISC provision.

Critics of DISCs contend that the subsidy, in addition to having only a modest effect on exports, has other flaws as well. They maintain that the subsidy is too inflexible to respond to changes in the overall U.S. trade position--in particular, that it cannot be reallocated easily as prospects for growth in the exports of some commodities improve or as the need to assist ailing industries grows. In addition, other countries see DISCs as illegal tax-subsidy vehicles violating the General Agreement on Tariffs and Trade (GATT). Some Members of Congress and Treasury officials are now examining various alternatives to DISCs, but most suggestions have concentrated so far on designing a subsidy that conforms with GATT, rather than on reducing the revenue loss from DISCs or a similar type of export subsidy.

REDUCE CREDIT FOR INCREMENTAL RESEARCH EXPENDITURES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.3	0.5	0.2	a/	a/	1.0

a. Less than $50 million.

The Economic Recovery Tax Act of 1981 authorized a nonrefundable 25 percent income tax credit for certain research expenditures. Qualifying expenditures are limited to those that exceed the average for the three preceeding taxable years; thus, the credit applies only to incremental expenditures above some approximation of the taxpayer's customary level. The credit is available only for research expenditures through the end of calendar year 1985. Reducing the credit to 10 percent as of December 31, 1983, would increase federal revenues by $0.3 billion in fiscal year 1984 and by $1.0 billion in total over the 1984-1988 period.

Critics argue that this credit is unnecessary and inefficient. Though expenditures that generate income over a number of years are generally written off for tax purposes over a like period, research expenditures can be written off completely in the first year. Thus, even without the credit, research expenditures have access to preferential treatment. The formula used to distinguish "incremental" from "customary" research expenditures also presents a number of problems. New firms are limited to a credit for only half of their expenditures, and research to explore an area in which a firm is not already doing business is not creditable at all. Restricting the credit to increases in research spending eliminates any incentive to troubled firms to maintain their research activities, since letting research spending fall can create a low base period and thus increase the credit in a later year. The credit could actually induce firms with ongoing research programs to postpone some of the activities for a year or more, in order to create such a low base period. Further, there is evidence that some foreign firms have moved research activities to the United States to obtain the tax credit, even though the fruits of the research are used mainly in their home countries. Finally, the availability of both first-year write-offs and the 25 percent credit might lead some firms to wasteful spending at the expense of the Treasury.

The credit for incremental research expenditures may be sufficiently inefficient or idiosyncratic that its revenue cost could better be devoted to maintaining other incentives for capital formation or innovation. Reducing the credit could also be justified as a deficit-reducing measure.

Proponents of the credit argue, on the other hand, that the payoff from investment in research and development is so uncertain and sometimes remote that firms will not invest sufficiently in such activities without some form of subsidy. Business investment in research and development has remained essentially flat in recent years, proponents argue, at levels below comparable spending in countries such as Japan and West Germany.

REPEAL PERCENTAGE DEPLETION ALLOWANCE FOR OIL AND GAS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.9	1.7	1.9	2.0	2.2	8.7

The Tax Reduction Act of 1975 repealed the percentage depletion allowance for major oil and gas companies and phased it down for independent producers. The percentage depletion rate for independent producers is 16 percent in 1983; it is to drop to 15 percent in 1984 and following years, and it is limited to an average of 1,000 barrels per day for each producer. (The rate is 22 percent for secondary and tertiary production until 1984, when it is to drop to 15 percent.) About one-fourth of oil and gas production is currently eligible for percentage depletion. Eliminating percentage depletion would increase federal revenues by about $8.7 billion over the 1984-1988 period.

Without percentage depletion, oil and gas producers would use cost depletion allowances, under which the actual cost of discovery and development can be written off over the producing life of a well. Producers would recover the amount of their investments, but no more. Under percentage depletion, the allowable percentage amount can be written off every year for as long as the well is in production; this, in combination with the expensing of intangible drilling costs, can allow the original cost of a well to be written off many times over the course of its life.

The oil and gas depletion allowance is defended as a necessary incentive for energy production--especially for independent producers, who may have less ready access to capital than do major oil and gas companies. The sharp rises in oil and gas prices in recent years, however, have greatly increased economic incentives to produce oil and gas. Since the allowance is a percentage of gross receipts, the value of the depletion allowance has increased accordingly. The 1,000-barrel-per-day limit permits independent producers with gross receipts exceeding $11 million a year to benefit from percentage depletion. Firms with gross receipts at that level are in the top 2 percent of all U.S. business firms and would be unlikely to encounter unusual difficulties in obtaining capital; therefore, their need for the percentage depletion allowance may be open to question.

REPEAL EXPENSING OF INTANGIBLE DRILLING COSTS FOR OIL AND GAS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	2.6	4.5	4.2	4.1	3.9	19.3

Under standard accounting practices, the cost of acquiring or improving an asset intended to produce income over several years is recaptured by a depreciation allowance spread over the useful life of that asset. Taxpayers engaged in oil and gas drilling, however, can generally deduct the amount they spend on "intangible drilling costs" in the year the expenditure is made--that is, they may "expense," rather than "capitalize," the qualifying costs. The costs that are permitted this special treatment include amounts paid for fuel, labor, repairs, hauling, and supplies used in drilling; the costs of clearing ground in preparation for drilling; and the intangible (that is, nonsalvagable) costs of constructing derricks, tanks, pipelines, and other structures and equipment necessary for the drilling and preparation of wells. Typically, these outlays account for about three-quarters of total costs. When these costs are expensed rather than capitalized, taxes on income are effectively deferred; the difference is tantamount to an interest-free loan in the amount of the delayed tax liability.

Under TEFRA, the expensing of intangible drilling costs was limited to 85 percent of otherwise allowable costs. The remaining 15 percent of allowable costs must be added to the cost of the oil, gas, or geothermal property and written off over a 36-month period. If expensing were repealed entirely, federal revenues would increase by about $19.3 billion over the 1984-1988 period.

The major argument for total repeal is that the subsidy is no longer necessary in light of the sharp increases in oil and gas prices in recent years, the decontrol of deep-well natural gas in November 1979 and of all domestically produced oil in January 1981, and the scheduled decontrol of most intrastate and newly drilled natural gas in 1985. Moreover, proponents of repeal argue that the expensing of intangible drilling costs is an ineffective subsidy for promoting high-risk exploratory drilling, since it provides the same incentive for low-risk drilling in already developed and producing fields as it does for exploratory drilling in new areas. If intangible drilling costs had to be capitalized, the costs of unproductive "dry holes" could continue to be written off immediately under normal accounting rules. This standard tax treatment would give exploratory drilling a comparative advantage over developmental drilling, thereby encouraging exploration.

Unlike the percentage depletion allowance for oil and gas (see previous Appendix item), which is no longer available to large oil and gas companies, the expensing of intangible drilling costs provides significant tax savings to major oil companies. In 1981, for example, the expensing of intangibles reduced Atlantic Richfield's effective tax rate by 6.0 percentage points, Exxon's by 6.3 percentage points, Gulf's by 3.9 percentage points, and Standard Oil of Indiana's by 6.1 percentage points. These companies were also able to take advantage of other preferential tax provisions, such as accelerated depreciation and the investment tax credit.

The major argument for retaining the expensing of intangibles is that oil and gas drilling is a high-risk investment that must be promoted for a more independent national energy supply. In addition, other intangible costs, such as exploration and development costs for minerals and fuels and some construction-period interest and taxes, also may be expensed rather than capitalized under current law. Finally, with the substantial increases in depreciation allowances and the investment tax credit enacted in 1981, many forms of equipment now receive tax treatment that is as favorable as expensing, and in some cases more so. Advocates of expensing argue that requiring the capitalization of intangible drilling costs would give these costs less favorable treatment than is now accorded to some investment in equipment and that some investment choices may therefore be distorted. Limits were put on the investment tax credit and the Accelerated Cost Recovery System of depreciation in TEFRA, but most equipment still receives more favorable treatment than intangible drilling costs would, were there no special tax preference for them.

REPEAL RESIDENTIAL ENERGY TAX CREDITS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.1	0.9	1.0	0.1	a/	2.0

a. Less than $50 million.

The Energy Tax Act of 1978 provided homeowners and renters a tax credit of 15 percent of the first $2,000 spent on insulation, storm windows and doors, caulking, and other expenditures made to conserve energy use in their principal residences. The credit applies only to residences built before April 20, 1977, and the cumulative credit per taxpayer for any one principal residence cannot exceed $300. Availability of the credit is scheduled to expire at the end of 1985. The same legislation also established a larger credit for the installation of solar, geothermal, wind, or other "renewable" energy equipment in a taxpayer's principal residence. Two years later, under the Crude Oil Windfall Profit Tax Act of 1980, the "renewable energy source" tax credit was raised to 40 percent of the first $10,000 spent, for a maximum credit of $4,000 on any one principal residence. The credit applies to equipment installed between April 20, 1977 and December 31, 1985.

According to preliminary data, the revenue loss in 1981 from the conservation credit was about $360 million, and the loss from the renewable energy source credit was about $260 million. Of the amount spent under the conservation tax credit, 87 percent was for insulation and storm windows or doors, and 94 percent of the amount spent under the renewable energy source tax credit was for solar energy equipment. Advancing the expiration dates for both of these credits to December 31, 1983 could increase federal revenues by about $2.0 billion over the 1984-1988 period.

After lengthy empirical analysis, a recent Congressional Research Service study concludes that there is little evidence thus far that the residential energy tax credits have been effective in promoting energy conservation. The study attributes most residential energy conservation in the last three years to rising energy prices. A substantial portion of the revenue loss from the energy tax credits may therefore represent a windfall to taxpayers for doing what high energy prices would induce them to do anyway. Also, with the decontrol of crude oil prices in January 1981, and with the scheduled partial decontrol of natural gas prices, the cost of energy has risen to world market price levels for oil and is approaching those levels for natural gas. Decontrol, therefore, may have already removed the need for additional energy-conservation incentives in the market.

One argument against repeal is that the reward of a tax credit may be more effective than high energy prices alone in stimulating conservation efforts, since it is more visible to homeowners, tangible, and easy to calculate than the cost savings from reduced energy use. Another argument is that many taxpayers have made their energy-conservation plans on the assumption that these credits would be available until the end of 1985; earlier repeal might be unfair to homeowners who have planned later conservation investments.

REPEAL BUSINESS ENERGY TAX INCENTIVES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.3	0.5	0.5	0.5	0.5	2.3

Although most business energy tax incentives expired on December 31, 1982, several of the larger ones will continue until the end of 1985 or later. Most of these are for equipment and technologies that supply energy: solar and wind equipment and technology for geothermal and ocean thermal energy conversion are eligible for a 15 percent investment credit; machinery to burn and convert biomass, a 10 percent investment credit; and small-scale hydroelectric facilities, an 11 percent investment credit. Those mentioned are scheduled to expire December 31, 1985, although some have lengthy carry-over rules. In addition, tax-exempt industrial development bonds may be issued to finance facilities that produce steam or alcohol from solid waste, small-scale hydroelectric facilities (until the end of 1985), and (in Oregon only) renewable energy property.

Production of alternative fuels is eligible for a tax credit until December 31, 2000 (with some exceptions), depending on the price of oil. This credit is intended to encourage alternative fuel production during times when the deregulated price of oil is temporarily low (below $29.50 a barrel, adjusted for inflation since 1979). Because of the recent lower oil prices, the credit has been in effect since 1981. The alcohol fuel tax credit and excise tax exemption, slated to expire December 31, 1992, are also intended to promote the use of nonpetroleum fuels. One conservation tax incentive, the 10 percent investment credit for intercity buses, is to remain in place until December 31, 1985.

Of the group, the largest revenue losers are the alternative fuel production credit and the investment credits for biomass equipment and small-scale hydroelectric facilities. The alternative fuel production credit represents 13 percent of the revenue gain in 1984 for repeal of all business energy tax incentives and about two-thirds of the revenue gain in 1988. Oil and gas prices are not projected to rise significantly in real terms over the period and the credit will therefore probably remain in effect until its expiration in the year 2000. In 1984, the biomass and hydroelectric credits are estimated to account for about 50 percent of the total business energy tax incentives' revenue loss of $0.4 billion, and in 1985, the last year they are to be in effect, about 65 percent. Repeal of all the business energy tax incentives would especially affect producers of paper and wood pulp products (who often supplement energy from other sources with hydroelectricity and the burning of wood chips), and other firms that use hydroelectricity and alternative fuels (mainly solar and wind) in their production processes. Biomass equipment and small-scale hydroelectric facilities are fairly conventional technologies; many firms installed them several years before the credits were enacted. To the extent that the credits help pay for investments that would be made in any event, repeal of these provisions would end some "windfall" tax savings.

The major argument in favor of the credits is that private individuals and firms considering only the dollar return to themselves from investments in energy production and conservation may not invest soon enough, or in large enough amounts, to meet the national energy and foreign policy goal of energy independence. Government subsidies may thus be justified as a way of meeting this larger public goal.

ELIMINATE CAPITAL GAINS TREATMENT OF TIMBER

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.2	0.6	0.7	0.8	0.8	3.1

Income from harvested timber held for at least one year before cutting is taxed at preferential capital gains rates. This special provision overrides the tax code's general denial of capital gains treatment to "stock in trade . . . or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business." (Otherwise any manufacturer could produce a product, put it on a shelf for one year before selling it, and reduce the tax owed by 60 percent.) Repealing this provision would add about $3.1 billion to federal revenues over the 1984-1988 period.

Advocates of repeal argue that the current large tax preferences for timber divert investment resources to timber from more productive uses. Besides having access to the capital gains tax preference, the timber industry also benefits from two other favorable tax provisions--the 10 percent investment tax credit and seven-year amortization for up to $10,000 of reforestation expenditures (enacted in 1980). The capital gains preference disproportionately benefits a small number of large timber-growing firms that also produce wood and paper. These firms can assign some of the taxable income from their other operations to the cutting of timber, thereby increasing their tax savings from the preference.

Defenders of the timber tax preference argue that its benefits have long been capitalized into timberland prices. More stringent tax treatment would likely depress the price of timberland, hitting hard at recent purchasers who expected tax code stability. Further, treating income from timber sales as ordinary income could promote abuses. Producers, rather than selling timber directly to processors and incurring ordinary tax liabilities, would be encouraged to transact artificial sales among one another (of both timber and timberland) in order to claim the proceeds as more advantageous capital gains. Finally, defenders argue that ordinary income treatment would be burdensome to producers because of the long development time of timber.

ELIMINATE TAX EXEMPTION FOR POLLUTION CONTROL BONDS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	a/	0.1	0.2	0.4	0.5	1.2

a. Less than $50 million.

In 1982, sales of tax-exempt pollution control bonds, authorized under the Revenue Expenditure and Control Act of 1968, reached $6.1 billion, up from $3.9 billion in 1981, and accounted for approximately 7 percent of all new long-term tax-exempt bond issues. The bonds finance roughly 40 percent of all private investment in pollution control equipment. Eliminating the subsidy would add $1.2 billion to federal revenues in the 1984-1988 period.

Availability of the bonds--or any other subsidy for pollution control--can have only limited influence on a company's decision to invest in pollution control equipment. Federal pollution control regulations are highly prescriptive, so that existing firms have little choice but to make the improvement required.

Advocates of eliminating the use of tax-exempt bonds for pollution control cite several arguments. The large business tax cuts in ERTA may have reduced the need for interest-cost subsidies in general. Even if they had not, a direct subsidy would be less costly than tax-exempt bonds, because it would provide benefits only to the investor in pollution control equipment. With tax-exempt bonds, bondholders and intermediaries also realize gains. Moreover, substituting direct subsidies for tax-exempt bonds would ease the strain on municipal bond interest rates, which in the past two years have been approaching those for taxable issues. Finally, pollution control bonds encourage technological inefficiency, because they are available only for "end-of-pipe" capital investments, such as "scrubbers," which are used to remove sulpher dioxide emissions from combustion processes. Thus, they discourage selection of other, possibly more effective, solutions to underlying pollution problems--such as the use of less-polluting raw materials or production methods.

LIMIT NONBUSINESS, NON-INVESTMENT INTEREST DEDUCTIONS TO $10,000

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.6	1.8	2.0	2.2	2.4	9.0

Taxpayers who itemize can deduct all interest payments on home mortgages, auto loans and other installment purchases, credit card carryovers, and other consumption borrowing. The only limit, enacted in 1976, is on investment borrowing; investment interest deductions are limited to $10,000 in excess of investment income. In 1980, 27 million individuals and families deducted about $80 billion of interest on consumption borrowing--an average of $3,000. Sixty-seven million other taxpayers, most with lower incomes, did not deduct any interest.

Limiting all nonbusiness non-investment interest deductions to $10,000, paralleling the limit on investment interest deductions, would affect 1 percent of all taxpayers and raise $9.0 billion from 1984 through 1988. Alternatively, disallowing 3 percent of each taxpayer's nonbusiness non-investment interest deductions would raise about the same amount of revenue.

Most economic concepts of income would not allow interest deductions for loans to finance housing, consumer durables, or other consumption because this interest is not a cost of earning taxable income. Nonetheless, consumer interest deductions have been permitted since the beginning of the income tax in 1913. The deduction had relatively little impact until the 1940s, however, when higher tax rates and the rise of long-term home mortgages turned it into a major incentive for homeownership.

A $10,000 cap on interest deductions would leave a substantial incentive for home or other consumer borrowing. At a 14 percent interest rate, interest on borrowings up to $71,000 would be fully deductible; at 10 percent, the limit would be $100,000. The incentive would cease above these limits, making larger investments in housing and other consumer borrowing less advantageous. In the current recession, continued incentives for housing, autos, and consumer durables may be desirable. Once recovery comes, though, decreased incentives for consumer borrowing would free savings for business investment that increases productivity and economic growth.

Applying the interest cap to existing loans would affect few taxpayers, but those with interest deductions well above the limit could find their current income strained. Also, those with homes costing over $100,000 would probably suffer some decline in real estate value. Delaying implementation of the limit for two years would give affected persons time to realign their yearly expenses, although the delay would not ease the impact on home values much. Alternatively, implementing a small percentage disallowance on all consumer interest deductions would affect every taxpayer who itemizes interest payments, but no one very much. This latter approach would also reduce every itemizer's incentive for consumption borrowing rather than severely reducing it for just a few.

The separate $10,000 limits on consumption and investment interest deductions suggested here would permit taxpayers with assets to disguise a portion of their borrowing as investment borrowing and thereby deduct more than $10,000 in consumption interest. For example, a landowner could borrow against the land and purchase a car. This fungibility between the two limits could be reduced by strict enforcement of rules distinguishing between consumption and investment borrowing or by a single limit for both. Either approach would raise more revenue, but strict enforcement would require a difficult tracing of the uses made of borrowed funds, and a combined limit could squeeze out legitimate investment interest deductions.

Exempting homeowners' mortgage interest would greatly expand the opportunity for taxpayers to avoid the limit. Most taxpayers who itemize are homeowners, and most homeowners could hide their other consumption borrowing by taking out a loan against their home. The limit on all consumption interest is harder to evade.

TAX 10 PERCENT OF THE CAPITAL GAINS ON HOME SALES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	--	0.8	1.0	1.2	1.4	4.4

Capital gains taxes on home sales may be deferred so long as the seller buys another home costing at least as much as the one sold within two years. In addition, the first $125,000 of capital gains on a home sold by a person aged 55 or over is not taxed at all. Replacing these provisions with a tax on 10 percent of all accrued long-term capital gains on home sales would add about $4.4 billion to federal revenues in the 1984-1988 period.

The tax deferral, enacted in 1951, was intended to prevent hardships for owners who had to sell because of an increase in family size or an unexpected employment change. The exclusion for elderly homeowners, first enacted in 1964 and most recently liberalized in 1981, was designed to obviate a large tax liability after a lifetime of home price increases, with much of the increase perhaps due to to inflation.

During the 1970s, homeownership came increasingly to be viewed as an excellent financial investment, competing with other forms of investment for household savings. To the extent that the tax system favors capital gains from homeownership over capital gains from stock and other forms of business investment, savings are diverted from business investments into homes.

Replacing both provisions--the tax deferral and the $125,000 exclusion--with a small tax on long-term capital gains on housing would make the treatment of housing more like that of other assets. If 10 percent of the gain were taxed, instead of 40 percent as on other long-term gains, the tax on home gains would never exceed 5 percent of the total gain, and would be less for taxpayers with marginal income tax rates below the top 50 percent rate. Also, by reducing the need for homeowners to keep track of gains and expenses on a lifetime of principal residences, this option would simplify both tax administration and taxpayer compliance.

If the option applied to gains accrued throughout the period of ownership, rather than just to those occurring after the date of enactment, it would have some of its most pronounced effects on persons who owned homes in the early 1970s and therefore benefited from the fixed-interest mortgages and rapidly increasing home prices that made homeownership such a good investment during that decade. If only gains occurring after the date of enactment were taxed, the option would affect mainly new home purchasers, who face an environment in which mortgages with high and variable interest rates have made homeownership a less desirable financial investment. Also, applying the tax just to gains occurring after the date of enactment would be administratively difficult because there is no convenient, equitable method for allocating the accumulated gain beween pre-and post-enactment periods of ownership. The option discussed here thus assumes that 10 percent of all accrued gains are taxed at the time of sale.

LENGTHEN THE BUILDING DEPRECIATION PERIOD TO 20 YEARS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.4	1.8	3.7	5.7	7.7	19.3

Under ERTA, both new and newly-purchased buildings can be depreciated over 15 years using the 175 percent declining balance method. 1/ The 15 year life is reduced from about 30 years under prior law. The 175 percent declining balance method is a speedup for all existing buildings and new nonresidential structures; it is a slow-down for new rental housing, but the halving of the tax life more than offsets the slow-down.

The 1981 law also increased tax incentives for investment in equipment, particularly through the investment tax credit (examined elsewhere in this Appendix). In 1982, TEFRA rescinded up to 80 percent of ERTA's incentives for investment in equipment while rescinding none of those for investment in structures. Rescinding a portion of ERTA's incentives for investment in structures would restore the historical balance between equipment and structure investments. It would also raise substantial revenue; lengthening structures' tax life from 15 years to 20 years would raise $0.4 billion in 1984 and $19.3 billion over the five-year period 1984-1988.

Although TEFRA raised taxes on equipment and not those on structures, corporate tax provisions historically have favored--and since TEFRA, still do favor--investment in equipment over structures. (The main reason is that equipment is eligible for an investment tax credit, while structures are not). Therefore, TEFRA's increases can be seen as partially redressing an historical imbalance. Calculations of effective corporate tax rates after TEFRA find a nearly zero-percent rate on equipment and a 30 percent to 40 percent rate on structures.

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1. The 175 percent declining balance method raises straight-line depreciation by 175 percent in the first year. In the second and subsequent years, the balance remaining is depreciated at 175 percent of its straight-line amount. In later years, the declining balance method yields less rapid write-offs than does straight-line on the remaining balance. At that time, depreciation schedules switch to straight-line.

Though effective tax rates on corporate investment in structures are higher than on equipment, only about half of the depreciable buildings are held by corporations. The other half, mostly rental housing projects, office buildings, and some commercial buildings, frequently serve as tax shelters for individuals and probably bear substantially lower effective tax rates than corporate structures. Unlike corporations, tax shelter investors borrow almost all the amounts needed to purchase structures, thereby obtaining substantial interest deductions. They then sell the buildings as soon as the main depreciation advantages have been claimed. CBO has not calculated the effective tax rates for all types of tax-sheltered building investments, but other sources show that ERTA raised the value of new residential tax-shelter projects by 30 percent to 50 percent. In a period of large budget deficits, recently conferred gains to tax shelter investments could arguably be reduced, as lengthening the tax-life to 20 years would do. The added imbalance caused for corporate tax treatment of buildings and equipment could be offset by raising the effective tax rate on corporate equipment investments.

The construction industry is one of the hardest hit in the current recession: its unemployment rate is double the national average. Reductions now in the tax incentives for buildings could delay recovery in this sector. Tax increases enacted now but taking effect after the recovery begins, however, might spur new building now, when it is needed, and raise revenue once construction needs less stimulation.

TAX THE ACCRUED INTEREST ON LIFE INSURANCE RESERVES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	2.1	5.8	6.6	7.6	8.7	30.8

Premiums paid for whole life insurance policies can be divided into the price of death protection and a separate saving component. While death benefits paid out by insurance companies on average approximately equal the death protection component of the premiums paid in each year, the saving component builds up as a reserve or cash value that earns interest year by year.

Attributing, on a current basis, interest on life insurance reserves to policyholders for income tax purposes (even though they did not receive the interest in cash) would raise $2.1 billion in 1984, and $30.8 billion over the 1984-1988 period. About 25 million tax returns would be affected. The impact on the least-affluent policyholders could be reduced by taxing only interest in excess of some floor, perhaps $100 a year. Such a limit would likely reduce the revenue gain by about half.

In most respects, saving through whole life insurance is identical to saving through other interest-bearing instruments. Interest earned on life insurance reserves receives a special tax advantage, however, since the interest is not taxable until the policy matures. At the same time, interest paid by policyholders on their policy loans is tax deductible. Though whole life insurance policies have until recently offered low guaranteed rates of return through conservative investments of premiums, new policies are now being offered with much higher rates of return to capitalize on this tax advantage. Unlike tax-deferred individual retirement accounts (IRAs), in which money must be deposited until retirement age to avoid stiff penalties, whole life insurance policies can be tailored to allow policyholders easy and early access to their funds.

Opponents of the exclusion of life insurance interest argue that life insurance companies can invest their policyholders' savings tax free, while the policyholder investing in the same assets either directly or through a mutual fund is subject to tax. The Internal Revenue Service recently tightened requirements for the very similar so-called "wrap-around annuities," but experience suggests that tax can be avoided on virtually any investment by calling it insurance and purchasing it through an insurance company according to certain technical restrictions. Such a tax avoidance opportunity is arguably unfair and inefficient.

Advocates of excluding life insurance interest argue that the interest is not received in cash until the policy matures (though this is also true of some long-term bank deposit certificates, the interest on which is taxed currently). They also contend that the uncertainty of earnings would cause taxation to be a disruptive burden to the entire life insurance industry, and make whole life insurance much less attractive.

REPEAL NET INTEREST EXCLUSION

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	--	1.1	3.0	3.4	3.7	11.2

Under ERTA a tax exclusion of 15 percent of the first $3,000 of net interest income on individual returns and $6,000 on joint returns is to become effective January 1, 1985. Net interest income is the difference between total taxable interest income and total itemized interest payments (exclusive of mortgage and business interest deductions). Repeal of the net interest exclusion would raise $1.1 billion in 1985 and $11.2 billion from 1985 through 1988.

The provision was enacted to encourage saving and thereby investment and economic growth. Proponents point out that, compared with some faster-growing nations, the United States has higher taxes on saving and a lower saving rate. They also note that taxation of interest payments is excessive in periods of high inflation, because part of the payment is compensation for erosion of principal rather than real interest income. This factor, along with the deductibility of interest payments, is said to favor borrowing and discourage saving. The partial exclusion of interest income would redress these imbalances by increasing the reward to saving, which, it is hoped, will increase total savings.

Objections to the credit range from doubts about its effectiveness in increasing saving to questions about the underlying principle of favoring saving. Doubts about the credit's effectiveness at stimulating saving arise from the historical record. Apart from war years and normal cyclical fluctuations, the saving rate in the United States has been stable at least since 1900, in spite of large changes in inflation and tax rates. Also, in defining net interest income, mortgage interest deductions are not offset against interest earnings so a homeowner who takes out a larger-than-necessary mortgage and invests the extra funds could claim the credit without saving more. Doubts about the need for the credit have also been raised by the sharp decline in inflation since ERTA was enacted and by ERTA's reduction in marginal tax rates. Objections to the principle of favoring saving are based on the idea that economic efficiency is best served if all forms of income are taxed alike and at the lowest rates. From this viewpoint, an exclusion of interest income from the tax base would mean that tax rates must be higher on other activities--such as work and investment in non-interest-bearing assets--and thus, these other activities are discouraged.

If the interest exclusion were repealed, saving and investment could still be encouraged by restricting existing tax incentives for consumer borrowing. For example, itemized deductions on home mortgage interest and other consumer interest could be reduced by 3 percent, as discussed elsewhere in this Appendix. Besides discouraging borrowing, the additional revenue raised from limiting interest deductions could be used to reduce income tax rates, which would encourage both saving and work equally; or the revenue could be used to reduce the federal deficit further, which would free existing savings for private investment.

ELIMINATE TAX EXEMPTION FOR SMALL ISSUE INDUSTRIAL REVENUE BONDS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	a/	0.3	0.7	1.2	1.5	3.7

a. Less than $50 million.

Small issue industrial revenue bonds (IRBs), issued by state and local government agencies and exempt from federal taxation, in effect subsidize private businesses by enabling them to borrow for plant and equipment at below-market municipal bond interest rates. Before the 1960s, IRBs were used infrequently. But growth in sales from roughly $100 million in 1960 to $1.8 bilion in 1968 led the Congress to limit their use. The bonds are now issued either for special purposes, such as pollution control (treated as another item in this Appendix), or are limited to "small issues" (now $10 million or less) regardless of purpose. Eliminating the tax exemption for small issue IRBs would raise $3.7 billion in new revenue over the 1984-1988 period.

Small issues finance a wide variety of enterprises. In 1981, they amounted to more than $11.0 billion (up from $8.4 billion in 1980) and accounted for about 20 percent of all new long-term tax-exempt bond issues. Preliminary indications are that the volume of issues in 1982 was 25 percent greater than in 1981. Although TEFRA imposed some restrictions, the volume of bonds will continue to grow until 1987, when small issue IRBs will no longer be exempt from taxation. Under TEFRA, most projects financed with small issue IRBs are ineligible for the accelerated rates of depreciation enacted in ERTA. But since IRB-financed plant and equipment can benefit from the shorter depreciation recovery periods that were also enacted in 1981, tax-exempt financing continues to be highly advantageous. Restrictions in TEFRA will limit the use of small issues for restaurants, bars, and other entertainment and recreational facilities, but growth in the use of the bonds for other purposes, including agricultural land and equipment, is likely to cancel out the savings that might otherwise have resulted from the legislation.

Even with the restrictions in TEFRA, IRBs are more broadly available than any direct federal assistance to private businesses. Aid under such programs is generally limited to specific geographic areas in need of economic development assistance or to specific businesses that have difficulty obtaining conventional credit.

Advocates of continued tax exemption for small issue IRBs maintain that the bonds stimulate investment and promote job development. Opponents argue that, since not all projects are eligible for IRB financing, the primary effect of the interest subsidy is to shift the allocation of investment dollars, rather than to increase the total amount of investment. Total investment is more likely to increase in response to general business tax cuts, critics argue.

LIMIT TO 50 PERCENT OF AMOUNT SPENT THE TAX DEDUCTION FOR BUSINESS ENTERTAINMENT AND MEALS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.5	1.1	1.2	1.4	1.5	5.7

Firms and individuals may deduct from taxable income the full amount spent on business meals and other forms of entertainment as "ordinary and necessary" business expenses if the meal or entertainment is directly related to or associated with the firm's business. Limiting business meal and entertainment expense deductions to 50 percent of the amount spent would increase revenues by an estimated $5.7 billion in the 1984-1988 period.

This deduction has been the subject of continuing controversy. Opponents argue that it provides a government subsidy for personal pleasures that have only a remote business purpose; defenders counter that the conduct of business is greatly facilitated by such expenditures. Both the Kennedy Administration (in 1961-1962) and the Carter Adminitration (in 1978) proposed major cutbacks in business meal and entertainment deductions. But opposition from the hotel, restaurant, and resort industries and their employees prevented significant changes. Last year, the Senate approved an amendment limiting the deduction for business meals to 50 percent of the amount spent, but the plan was dropped in conference with the House.

Difficulties often arise in drawing a line between ordinary and necessary--hence deductible--business expenses and nondeductible personal expenses. If the line were drawn at expenses that serve the personal pleasure, comfort, or convenience of business executives and employees, for example, many common expenses--lavish offices, company automobiles and airplanes, and expensive midtown lodgings for traveling executives--might become nondeductible. Limiting deductible meal expenses to a specific dollar amount would not take into account the wide variation in restaurant meal costs, and would not, in fact, distinguish business from nonbusiness meals.

To avoid these line-drawing problems, but at the same time to restrain the government's subsidy for business meals and entertainment, deductions for these expenses could be limited to 50 percent of the amount spent. In the case of corporations, to which a top marginal tax rate of 46 percent applies, the government would then, in effect, pay 23 percent of the cost (half of 46 percent) rather than the full 46 percent. Because businesses would have to pay a larger share of the costs of meal and entertainment expenses, they would likely impose somewhat tighter internal controls on these expenses. Firms themselves would have to consider more carefully whether a particular expense was closely enough related to an important business purpose to justify it.

REQUIRE FULL BASIS ADJUSTMENT FOR THE INVESTMENT TAX CREDIT

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.3	1.2	2.4	3.6	4.9	12.4

Currently, taxpayers are allowed tax credits for certain authorized investments--for example, in general machinery and equipment, energy conservation equipment, and rehabilitation of certified historical structures. The tax credit for property with a five-year tax life (which includes most investment) is 10 percent, effectively reducing the acquisition cost to the investing firm by 10 percent. Prior to TEFRA, firms were allowed to depreciate 100 percent of an asset's price according to prescribed schedules. This allowed firms to receive two overlapping tax benefits for the same investment: one benefit paying for 10 percent of the asset's cost, and the other allowing the firm to depreciate that 10 percent as well as the other 90 percent of the cost of the asset. This overlap could be avoided through a "basis adjustment" that would reduce the amount that can be depreciated by the amount of the credit. Such a basis adjustment was required when the regular investment tax credit was enacted in 1962, but the adjustment was repealed after two years. In TEFRA, the Congress limited the depreciable basis of an asset to its price less 50 percent of the eligible credit; thus, in the case of the regular credit, firms may now only depreciate 95 percent of an asset's price. A full basis adjustment would restrict depreciation to the firm's net cost of the asset--90 percent in the case of the regular investment credit. This proposal, if applied to the regular investment credit for machinery and equipment, would raise $0.3 billion in 1984 and $12.4 billion from 1984 to 1988.

The allowance of depreciation deductions as well as the investment credit on a portion of an asset's cost (currently 5 percent) has been justified as a way of encouraging investment. The double benefit results in effective tax rates on new equipment investment close to zero on average at 6 percent inflation. This has been criticized, however, as furnishing an overly generous tax subsidy for investment. A 100 percent basis adjustment would result in tax rates on investment that are positive, but well below the statutory corporate tax rate of 46 percent; the rates on most new equipment in the corporate sector would be in the range of 5 to 20 percent.

ELIMINATE THE ACCUMULATED EARNINGS ALLOWANCE FOR PERSONAL SERVICE CORPORATIONS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.1	0.4	0.4	0.5	0.5	1.9

At present, corporations are taxed at rates ranging from 15 percent on the first $25,000 of income to 46 percent on income of more than $100,000:

Taxable Income	Tax Rate (Percent)
$0 - $25,000	15
25,000 - 50,000	18
50,001 - 75,000	30
75,001 - 100,000	40
100,000 and above	46

The lower rates on income of less than $100,000 have both positive and negative effects. Smaller and newer firms benefit from a progressive rate structure. But the structure also encourages self-employed persons earning $100,000 or more a year to incorporate so that they can shield ordinary income from taxation at individual rates (which currently range up to 50 percent for income exceeding $85,000).

Those most likely to incorporate are entertainers, brokers, consultants, and other professionals such as physicians and accountants, who form either personal-service or professional corporations. These corporations loan out or hire the incorporator's services at a salary that is set forth in an employment contract. This permits the first $100,000 (and, in particular, the first $75,000) of income to be taxed at much lower rates if retained as corporate earnings.

Personal service corporations may accumulate up to $150,000 in retained earnings for the "reasonable" needs of the business. Savings are greatest if the amount retained falls within the lowest 15 percent tax bracket. Thus, an actor may earn, after expenses, $200,000 a year; pay himself or herself a salary of $175,000 which would be taxed at individual rates; and let the "corporation" retain $25,000, which would be taxed at 15 percent. This procedure could be repeated for six years for a tax saving of $52,500. (Retained earnings of $50,000 a year for three years would result in tax savings of $52,250.)

One remedy would be simply to eliminate the graduation in the corporate tax rate, leaving a 46 percent flat rate. The argument against doing away with a progressive corporate tax structure is that not all small businesses are personal service corporations, and some companies, particularly fledgling firms that are just beginning to show profits, would be adversely affected.

An alternative would be to tax the net income of personal service corporations at individual rates. This would result in savings to the federal government of about $100 million in 1984 and $1.9 billion in the 1984-1988 period. ERTA set a precedent for distinguishing between personal service and other corporations: the act increased the accumulated earnings allowance from $150,000 to $250,000 for all but personal service corporations in the fields of health, law, accounting, engineering, architecture, performing arts, and consulting. If personal service corporations became ineligible for the accumulated earnings allowance, the tax shelter could be eliminated with no adverse effects on economic growth.

ELIMINATE TAX CREDITS FOR REHABILITATING OLDER BUILDINGS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.8	1.2	1.4	1.6	1.8	6.8

The Congress has enacted large tax credits for amounts spent rehabilitating older income-producing buildings. The credits were designed to encourage businesses to renovate their existing premises rather than to relocate, to encourage people to purchase and put to new use older buildings that have outlived their original usefulness, and to encourage the preservation of historic buildings. The credits range from 15 to 25 percent, depending on the age of the building and whether it is registered with the Department of the Interior as an historic structure. Eliminating the tax credits would save $6.8 billion over the 1984-1988 period. Retaining only a 15 percent credit for certified historic renovations would save $0.6 billion in 1984, growing to $1.3 billion in 1988, for a five-year savings of $5.1 billion.

Because the current tax credits are so large, they seem certain to promote a great deal of renovation as interest rates fall and the economy revives. Their size also, however, ensures that many owners will receive large tax savings for doing what they would have done even if the credits did not exist or were not so large. Moreover, since the credits are available for rehabilitation of commercial buildings only and not for rental housing (with the exception of housing in historic buildings), they will promote the conversion of some structures to commercial use and generally draw investment funds away from rental housing. They will similarly draw funds away from some new construction that could have contributed more to the efficient operation of the economy than the renovation that takes its place.

Retaining a credit just for renovation of certified historic buildings would limit the tax loss to projects clearly preserving historic buildings. Preliminary surveys indicate a 15 percent credit would be sufficient to cover the extra costs of certification and historic-quality rehabilitation. Finally, retaining only the historic credit would remove the incentive for converting older rental housing to commercial use.

REPEAL EXTRA PARENTAL PERSONAL EXEMPTION FOR STUDENTS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.3	0.8	0.8	0.9	0.9	3.7

Until a child turns 19, the parents can claim an exemption of $1,000 if they contribute at least half of the child's support. Beyond that age, an additional test is imposed--the child must earn less than $1,000 to qualify as a dependent. If the child is a student, however, the parents can claim an exemption regardless of the student's income, so long as they provide half the support. If the special exemption for students was repealed effective January 1, 1984, the increased federal revenues over the 1984-1988 period would total about $3.7 billion.

The rule allowing a parental personal exemption for students, even if they earn more than the amount of the exemption, was adopted in 1954. The main reason for the rule was to avoid the "notch" problem that resulted when a dependent's earnings were close to the exemption amount; an extra few dollars in earnings could deprive the parents of the exemption, costing them hundreds of dollars in extra taxes. Even though parents who support nonstudents aged 19 and over also face this problem under present law, most nonstudents earn well over $1,000 a year so that the notch problem normally does not arise. Students, who often work only part time, are much more likely to have earnings for the year that come close to the $1,000 dividing line. The exemption was also justified as a way of taking into account the added costs parents incur for students.

This provision has been criticized as inequitable because it subsidizes households that send their children to college at the expense of those whose children go straight to work. In effect, the exemption provides a tax subsidy for higher education. In light of the fact that the exemption is worth more to households in higher tax brackets, the subsidy benefits most those who may need it least.

TAX NONSTATUTORY FRINGE BENEFITS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.6	1.2	1.3	1.5	1.8	6.4

The Congress has for several years prohibited the Internal Revenue Service (IRS) from publishing regulations for the taxation of "fringe benefits," which are certain forms of nonwage employee compensation. Although fringe benefits are legally subject to tax, they cannot be taxed on a consistent basis without comprehensive regulations, and so in practice they have generally been excluded from taxation. Examples of such benefits are the private use of a company car, discounts on employers' products, reduced-price meals, subsidized day care, reimbursement for recreational expenditures while on business travel, tickets to sporting or cultural events, and club dues. (Some other fringe benefits, such as employer contributions for life and health insurance premiums, are specifically excluded from taxation by law and thus do not fall into this category.) If the Congress would permit the IRS to issue regulations governing the taxation of these fringe benefits, the revenue gain over 1984-1988 could be about $6 billion.

At present, a taxpayer with no employer-provided fringe benefits pays the same tax as another with an equal salary and generous fringe benefits. Employees have a strong incentive to bargain for more of their compensation in the form of untaxed fringe benefits. This shrinks the overall tax base, increases the tax rates necessary for all taxpayers, and--in a continuing cycle--further increases the incentive to bargain for untaxed fringe benefits. The exemption from tax further misallocates resources by inducing employees to bargain for fringe benefits that they would not buy themselves. Thus, an employee in the 30 percent tax bracket is encouraged by the tax exemption to seek fringe benefits costing the employer $1 that the employee would not buy for more than 70 cents.

Taxing some fringe benefits, such as small employee discounts, would involve collection costs greater than the revenue to be collected; but larger items could be taxed cost-effectively. In all likelihood, some fringe benefits would be converted to cash income by mutual agreement of employers and employees; this would add to tax revenues in the same way as the direct taxation of fringe benefits.

LIMIT CHARITABLE DEDUCTION FOR NON-ITEMIZERS TO $100

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	--	0.2	1.9	3.6	--	5.7

Under a provision of ERTA, taxpayers who claim the standard deduction can also claim a separate itemized deduction for contributions to charitable organizations (as defined for the usual itemized deduction). The special itemized deduction is phased in over the period 1982-1986; for 1982 the deduction is limited to 25 percent of no more than $100 of contributions, but by 1986 both the percentage and the dollar limits are eliminated. The provision is scheduled to expire at the end of 1986.

The special charitable contributions deduction for nonitemizers will reduce federal revenues by $0.7 billion in 1985 and $2.7 billion in 1986. One way to hold this revenue loss in check would be to limit the deduction to $100 while allowing the percentage limit to increase as scheduled. Such a limit would increase federal individual income tax revenues by $5.7 billion over the lifetime of the provision.

While the encouragement of charitable giving is desirable, a case can be made against the special itemized deduction. Though the provision may seem to afford the same incentive and benefit of a deduction for charitable contributions as have previously been given to itemizers, in fact the incentive and the benefit are both small. Because nonitemizers tend to be those with the lowest incomes and in the lowest tax rate brackets, both their ability to give and the incentive effect of the special deduction are still quite limited despite the special deduction. The special deduction also loses tax revenue for contributions that nonitemizers would have made even in the absence of the provision, reducing its cost-effectiveness in stimulating new giving. The provision requires additional recordkeeping and computations from the 69 percent of taxfilers who now claim the standard deduction, for whom tax simplification has been an important objective. At the same time, the Internal Revenue Service is likely to be confronted with millions of tax returns claiming small deductions for charitable contributions; these deductions will be difficult and costly to verify, but taken together will have tremendous potential for abuse.

The special deduction for charitable contributions threatens to undermine recent steps toward tax simplification. The Congress in recent years has substantially increased the standard deduction (or "zero bracket amount"), at least in part to save taxpayers the difficulty and expense of itemizing numerous deductions. The special charitable deduction is a significant departure from this trend. It may also be a precedent for the creation of further "add on" deductions, thereby undermining the purpose of the standard deduction and complicating the tax filing process for those most in need of simplification.

REPEAL THE TAX CREDIT FOR EMPLOYEE STOCK OWNERSHIP PLANS

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.7	1.7	2.1	2.3	1.1	7.8

An Employee Stock Ownership Plan (ESOP) acquires and holds the firm's stock for the benefit of its employees. As long as rules similar to those for employer-paid pensions are followed, contributions to the plan are tax deferred until they are distributed. A tax-credit ESOP is one to which an employer either contributes stock or cash to buy stock; the employer receives a tax credit for the contribution. (Other ESOPs, called "leveraged ESOPs," are ineligible for the tax credit.[1]) In 1975, when the Congress first enacted the ESOP tax credit, it was an add-on to the investment tax credit and was to expire in 1976. The credit has been modified and extended several times since its inception and is now scheduled to expire in 1987. The tax credit allows employers to recover fully their ESOP contribution up to a limit based--in 1983 and later years--on earnings of covered employees. Repealing the credit as of 1984 would raise revenues by $0.7 billion in the first year and by a total of $7.8 billion through its currently legislated expiration.

The prime benefit of the tax credit is that it strongly encourages corporations to set up and contribute to ESOPs. Because ESOPs give employees a stake in their business, they may improve employee motivation, raise productivity and enhance company profits. Several corporations report ESOPs have had these desirable effects while others find no change. Proponents argue that in addition to improving motivation, ESOPs broaden

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1. A leveraged ESOP borrows from a financial institution to buy employer stock and then repays the loan over time out of employer contributions to the plan. Employer contributions to the leveraged ESOP are deductible (up to a limit based on total compensation) as part of overall employee compensation. Employers' contributions to tax-credit ESOPs are not deductible to the extent the credit is claimed.

ownership of corporate wealth, supplement labor income and extend political support for private enterprise.

The prime objection to continuation of the tax credit is one of equity. Through the tax credit the government is, in effect, buying corporate stock and giving it to trusts for particular individuals. These stock gifts are only available to employees of corporations choosing to participate in the plans. Because the credit originally was tied to the investment tax credit, tax credit ESOPs are currently concentrated among capital intensive corporations. The stock gifts are not available to employees of unincorporated businesses, to self-employed persons, or to such others as employees of not-for-profit organizations. Repeal of the tax credit would place tax credit ESOPs on a par with other fringe benefits such as pensions and health plans, and would make the tax base somewhat broader, thus potentially permitting tax rates to be slightly lower.

TAX SOME EMPLOYER-PAID HEALTH INSURANCE

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1984	1985	1986	1987	1988	Cumulative Five-Year Addition
Income Tax	2.7	4.9	6.0	7.2	8.7	29.6
Payroll Tax	0.8	1.5	1.9	2.2	2.6	9.1

Employees do not pay taxes on income received in the form of employer-paid health care coverage. This exclusion will reduce 1984 income tax revenues by about $20.2 billion--an amount comparable to total federal spending for Medicaid, the major program financing health care services for the poor. This form of income also escapes payroll taxation, costing the Social Security trust fund about $8.9 billion in lost 1984 revenues.

One proposal for limiting the present exclusion would be to treat as taxable income in 1984 any portion of employer contributions exceeding $160 a month for family coverage and $65 per month for individual coverage, with the amount indexed to medical care prices in future years. This is similar to the approach already adopted by the Congress in connection with employer-provided group life insurance. The proposal would raise income tax revenues by $2.7 billion and payroll tax revenues by $0.8 billion in 1984. Over the 1984-1988 period, the revenue increases would amount to $29.6 billion and $9.1 billion, respectively. Any "grandfathering" of existing contributions would reduce these revenue increases.

In 1984, such a limitation would affect about 40 percent of those who participate in employer-sponsored health insurance plans. Several bills introduced in the 97th Congress included similar limits, but none was acted on.

Both health-policy and tax-policy arguments have been made for limiting this exclusion. The exclusion leads to what many consider to be overly extensive health insurance coverage, which has expanded use of health care services unnecessarily and, consequently, driven up their prices. Moreover, the provision disproportionately benefits persons with higher incomes, both because they tend to have larger employer-paid health insurance premiums that are excluded from taxation and because they are in higher marginal tax brackets. The average annual tax benefit in 1983 for all households with incomes between $10,001 and $15,000 is $83; for all households with incomes between $50,001 and $100,000, it is $622.

Opponents of taxing any portion of employer-paid health insurance argue that present health insurance coverage is not excessive and that changing the current policy would result in less insurance coverage; this might, in turn, cause some people to forgo important medical care. Also, they argue that a uniform ceiling would have uneven effects, since a given employer contribution purchases different levels of coverage depending on several factors such as geographic location and the demographic characteristics of the firm's work force.

ELIMINATE TAX EXEMPTION FOR PRIVATE HOSPITAL BONDS

	Annual Added Revenues (billions of dollars)					Cumulative Five-year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.1	0.3	0.6	0.9	1.1	3.0

The volume of tax-exempt bonds used to finance construction of hospitals increased from $3.8 billion in 1981 to an estimated $6.9 billion in 1982, accounting for some 8 percent of all new long-term tax-exempt financing in that year. (Direct federal subsidies for new hospital construction have been unavailable since 1974, although minimal funds were subsequently authorized, primarily for rehabilitation of public hospitals.) Approximately half of all new hospital construction is financed with tax-exempt bonds. Eliminating the tax exemption would increase federal revenues by about $3.0 billion in the 1984-1988 period.

The necessity of providing subsidies for new hospital construction has come into question in recent years because the United States has a surplus of hospital beds. Most analysts concur that an average of four hospital beds for each 1,000 population is sufficient. At present, the ratio stands at 4.4 to 1,000; this would indicate an oversupply. The main argument against repealing the tax exemption for private hospital bonds is that, although the supply of hospital beds on a nationwide basis may be excessive, certain areas still lack adequate hospital facilities. A possible solution to this imbalance might be to target tax-exempt hospital bonds toward areas that have shortages of adequate facilities. Opponents of this approach argue, however, that tax-exempt financing cannot be as efficiently targeted toward specific geographic areas or toward specific types of funding needs as direct subsidies have been in the past. Also, direct subsidies may be a less expensive and more efficient alternative, since the entire subsidy would go to the institution; with tax-exempt bond financing, as much as one-third of the subsidy goes to bondholders, underwriters, and bond counsel. In addition, direct subsidies would help to relieve the pressures on the municipal bond market, where rates in some instances have climbed high enough to cancel out almost completely the savings usually realized from tax exemption.

ELIMINATE EXTRA TAX EXEMPTIONS FOR THE ELDERLY OR THE BLIND

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	1.0	2.5	2.6	2.8	2.9	11.8

Any taxpayer aged 65 or older or blind is permitted to claim an extra $1,000 exemption. The most widely perceived reasons for this feature of the tax law are the lower income and the extra costs of living (especially medical costs) of the aged or blind. Repeal of the extra exemption would increase revenues by $1.0 billion in 1984, and by $11.8 billion during the 1984-1988 period. Of this amount, 99 percent would be paid by the elderly.

The extra exemption is criticized on several grounds. Neither age nor blindness is itself proof of financial need; more than one-third of all 1980 tax returns with adjusted gross income (AGI) over $1 million claimed an extra exemption for age. Over 20 percent of the returns that claimed an elderly exemption had an AGI over $20,000, and AGI completely excludes any income from Social Security. Because the exemption saves more tax dollars for those in higher brackets, 33 percent of the current tax saving goes to the 11.7 percent of all elderly taxpayers with over $30,000 in AGI. The elderly whose income is so low that they do not file returns at all do not benefit from the exemption; in 1980 only 11.8 million exemptions were claimed by an estimated elderly population of 25.5 million.

This extra exemption was adopted when Social Security benefits were low and the elderly had a much higher poverty incidence than the population in general (35.2 percent versus 22.4 percent in 1959). In 1980, largely as a result of Social Security, only 15.7 percent of the aged were in poverty (compared with 13.0 percent for all persons). The elderly and the blind who are faced with extraordinary medical expenses can deduct them--an additional exemption is not needed for that purpose.

ELIMINATE INCOME AVERAGING

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	3.5	3.8	4.2	4.5	4.9	20.9

The tax code allows income averaging by taxpayers who experience large increases of income in a particular year. Without averaging, a taxpayer with an uneven flow of income would, under the progressive income tax rate structure, pay more taxes than one earning the same total income at a more constant rate over the same period.

The averaging provision, enacted in 1964 and liberalized in 1969, was specifically designed to allow more equitable treatment of taxpayers--inventors and authors, for example--who receive relatively large payoffs in a short period for efforts expended over several previous years. 1/ But owing to the rapid inflation during the 1970s, many taxpayers have become unintended beneficiaries--those with rapidly growing incomes (such as recent graduates of professional schools) or who have family members entering the labor force or changing from part-time to full-time employment.

The best available data (in a 1977 Treasury Department study) strongly suggest that there is as much fluctuation of income among the general population as among those who use the income averaging provision. The increased incomes of averagers were largely wages and salaries; more than 60 percent of averagers had wage and salary increases over $3,000. These characteristics--simple growth (rather than variability) of income and a predominance of wage and salary income--are not consistent with the original intent of the provision. In addition, as more taxpayers become potential beneficiaries, a larger total effort is expended in calculating liability and eligibility for averaging.

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1. The House Report on the 1964 Revenue Act said its purpose was "to accord those whose incomes . . . fluctuate widely from year to year the same treatment accorded those with relatively stable incomes."

While the revenue loss from averaging was modest in its early years, greater familiarity with and use of the provision together with the high rates of inflation and income growth in the 1970s have increased the loss substantially. Since 1964, the percentage of all filers averaging has expanded by about 16 times, from 0.38 percent to more than 6 percent in 1980. Averagers saved a total of $133 million in 1964; by 1980, the revenue loss from averaging exceeded $3.5 billion. Although averaging is expected to continue to grow with an expanding economy, it will be tempered by the lower inflation now being projected and by the indexing of the income tax scheduled to start in 1985. If income averaging were eliminated entirely, total revenues would increase by about $3.5 billion in 1984, rising to almost $5 billion by 1988. If averaging provisions were tightened, the revenue gain would be less but the originally targeted population would receive a larger share of the tax relief. For example, a requirement of a 140 percent increase over the average of four previous years' income, rather than the current 120 percent increase, would restrict the number of averagers. Dropping the $3,000 income-increase threshold would allow more low-income filers to qualify.

FREEZE ESTATE AND GIFT CREDIT AT EXEMPTION EQUIVALENT OF $275,000

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.0	0.5	1.1	1.8	2.6	6.1

The Economic Recovery Tax Act of 1981 substantially reduced taxes on estates and gifts over a six-year phase-in period. The act provides for a credit of $79,300 against estate and gift tax liabilities starting in 1983. This credit effectively exempts all estates valued under $275,000 from the estate tax, and is scheduled to rise in yearly steps to $192,800 in 1987, thereby exempting all estates worth less than $600,000. The estate tax exemption was set at $60,000 in 1942, which is equivalent to about $353,500 in today's dollars. Freezing the credit at its 1983 level would head off further revenue losses, thereby raising $6 billion over the 1984-1988 period.

The expanded estate tax credit was adopted as a way to offset the effects of inflation on estates and provide tax relief to small- or moderate-sized estates, especially those that primarily consist of family businesses. While freezing the credit at its 1983 level would rescind the scheduled increase in the credit applicable to estates valued over $275,000, it would not affect the other estate tax relief measures provided by ERTA. These include significant tax rate reductions, an unlimited marital deduction, and tax-preferred valuation of small firms and businesses.

Further expansion of the estate tax credit can be criticized on several grounds. According to 1979 data, only about 3.5 percent of those dying in 1979 at age 45 and over had estates valued at more than $250,000. Any extension of the credit thus applies to only a small percentage of very wealthy taxpayers. Although it has been argued that estates and gifts should not be taxed because they have already been subject to the personal income tax during the accumulation process, large estates often consist of unrealized and untaxed capital gains (for example, corporate stock or housing). In the case of assets transferred at death, the heir does not have to pay capital gains taxes on any increase in value occurring before the owner's death; accrued appreciation will go totally untaxed if it is also exempt from the estate tax. In 1979, 25 percent of the value of gross estates over $300,000 consisted of unrealized capital gains appreciation--over 50 percent derived from corporate stock holdings. Thus, freezing the estate tax credit would strengthen the only tax on capital gains at death.

ELIMINATE DEDUCTIBILITY OF STATE AND LOCAL SALES TAXES

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline	0.9	5.8	6.4	7.0	7.8	27.9

State and local sales taxes paid may be claimed as an itemized deduction. Eliminating the sales tax deduction would increase federal income tax revenues by $0.9 billion in 1984 and by $27.9 billion in 1984-1988. Should some states choose to shift from sales to other taxes to preserve deductibility for their residents, the revenue gain would be reduced.

Sales taxes reduce the taxpayer's net income, and thus his ability to pay federal taxes. Normally, however, only expenses that are relatively large and that vary substantially from one taxpayer to another are deductible on ability-to-pay grounds; small, uniform, and predictable expenses are ignored and implicitly taken into account when the "zero bracket amount," personal exemptions, and general tax rates are established. The sales tax is that kind of a small, uniform, and predictable expense. Sales taxes are collected in 45 of the 50 states; in 1980, the latest year for which detailed data are available, 95.6 percent of all itemizers claimed the deduction, in amounts varying only from 2.0 percent of adjusted gross income for taxpayers with $10,000 to $15,000 of income, to 0.2 percent for those with over $1 million of income. The sales tax deduction is usually a small item (less than half as large as real estate taxes and about a third of income taxes on average in 1980). Sales tax liabilities do not vary substantially from state to state.

Any ability-to-pay rationale for the sales tax deduction is further undermined by the way it is usually calculated. The deduction amounts in most cases come from printed tables based on the state and on the size and income of the family, and presented in the Form 1040 instructions. The deduction is thus usually not based on actual tax payments, and does not compensate for variations in the burden among taxpayers. Further, taxpayers can only justify a deduction of actual liabilities greater than the Internal Revenue Service (IRS) table value by documenting each of the hundreds of retail transactions they made during the year. (Alternatively, if a household made a major purchase such as an auto, it can claim the deduction from the IRS table plus a further deduction for the sales tax on the major item. Because the major purchase would likely displace some other consumption, this method probably overcorrects for ability to pay.) Thus, the sales tax deduction may be both the most imprecise and the most burdensome (in terms of recordkeeping) of all the itemized deductions.

Beyond the considerable revenue loss, the imprecision, and the complexity of the deduction, it also has unfortunate incentive effects on both taxpayers and state and local governments. For taxpayers, it marginally and indirectly reduces the cost of consumption at a time when many observers believe the nation would be better served by more saving. For state and local governments, the deduction cushions the burden of the sales tax on taxpayers; but the sales tax, because it adds to the price level, contributes to inflation at the retail level. If the states and localities shifted toward taxes that do not increase prices, this would temporarily decrease the rate of inflation directly, and indirectly reduce business costs through cost-of-living escalators in labor contracts. (Direct reductions of sales taxes would, of course, make consumption even more attractive.)

Advocates of the sales tax deduction argue that the federal government should not influence the states' choice of taxes through selective deductibility. Another argument is that use of the sales tax, popularly held to be a fair tax, should not be discouraged.

IMPROVE TAXPAYER COMPLIANCE

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1984	1985	1986	1987	1988	
Addition to CBO Baseline						
Improve Audit Coverage:						
Increased Collections	0.2	0.7	2.3	2.4	2.5	8.0
Administrative Outlay Cost	-0.1	-0.2	-0.4	-0.5	-0.5	-1.7
Withholding:						
Royalties	0.4	0.5	0.7	1.0	1.3	3.9
Independent Contractors	0.6	0.9	1.2	1.3	1.4	5.4
Net Deficit Reduction	1.1	1.9	3.7	4.2	4.7	15.6

Substantial evidence shows that compliance with the tax laws has been declining in recent years. The Internal Revenue Service (IRS) estimates that about $95 billion in taxes went unpaid in 1981, an increase of nearly 200 percent since 1973 (67 percent after adjusting for inflation). Although illegal activities, such as prostitution or drug trafficking, are responsible for part of the "tax gap," 90 percent of the revenue shortfall results from underreporting or nonreporting of income from legal activities. Income underreporting is thought to account for over two-thirds of the gap--an estimated $66.1 billion in 1981. Overstated expenses, deductions, and credits account for $12.3 billion, and nonfilers for $4.9 billion. The largest share of underreported income is in the unincorporated business sector--over $30 billion in 1981. While additional complicated rules and regulations would be undesirable, tax evasion imposes an unfair burden on taxpayers who honestly comply. Improving taxpayer compliance would increase both revenues and fairness. These benefits, however, must be weighed against the additional burdens of paperwork and recordkeeping that would be imposed on all taxpayers.

The Congress adopted several compliance provisions in 1982 in TEFRA that are projected to raise $51 billion over the 1984-1988 period. Other areas offer additional potential for improved compliance. The provisions outlined below could reduce the deficit $1.1 billion in 1984 and $15.6 billion over the 1984-1988 period.

Increased Audit Coverage. Examination resources at the IRS have not kept pace with either the workload or the increasing complexity of the tax code. Since 1976, audit coverage has fallen from 2.6 percent of all returns to an expected 1.7 percent in 1983. Adding new staff could have an immediate and high payoff in revenues--estimated by the IRS at about $6 or $7 for every $1 of outlay. A permanent increase in staff of 15,000 average positions (10,000 positions for additional audit coverage and 5,000 positions for increased matching of information returns) would be consistent with the sense-of-the-Congress resolution in TEFRA that sufficient funds should be provided to collect additional tax revenues of $1 billion in 1984 and $2 billion in 1985. This would raise audit coverage to 2.1 percent by 1986, yielding additional revenues of $0.2 billion in 1984 and $8.0 billion in 1984-1988. The additional revenues would be partly offset by $1.7 billion in 1984-1988 outlays for the additional positions.

Expanded Coverage of Withholding. Increasing the coverage of withholding and/or raising rates (when they are too low) could improve taxpayer compliance. In TEFRA, the Congress adopted withholding on interest and dividends and optional withholding on pensions, annuities, and lump-sum distributions. After these procedures have become established, the Congress might want to make withholding on pensions and other retirement income mandatory and/or increase withholding rates to reflect actual taxpayer tax rates.

Two other options would be to cover business royalty payments and the earnings of independent contractors. Current law provides for information reporting on all royalty payments in excess of $600 on an annual basis. Businesses could also be required to withhold taxes on royalty payments for items such as patents, copyrights, and oil and gas rights. Firms could be required, for example, to withhold taxes at a rate of 10 percent on all payments over $600 on an annual basis. This proposal would raise $0.4 billion in 1984 and $3.9 billion in 1984-1988. Current law also requires information returns to be filed by employers of independent contractors on aggregate annual payments in excess of $600. Withholding could be applied to these payments at a rate of 10 percent, and contractors provided a W-2 form. This proposal would raise $0.6 in 1984 and $5.4 billion in 1984-1988.

Improved Recordkeeping. Unincorporated businesses are the largest source of tax evasion. Although it is extremely difficult to control or detect unrecorded cash transactions, this practice could be inhibited by increasing the penalty for negligent recordkeeping. Current law provides that taxpayers shall be fined 5 percent of their tax underpayment and 50 percent of the interest due on the underpayment if any part of an underpayment results from negligence or intentional disregard of rules and regulations, but without intent to defraud. Failure to maintain adequate records, regardless of intent, makes it difficult for the IRS to audit taxpayers and estimate true tax liabilities.

A new civil penalty for negligent recordkeeping could be instituted establishing a minimum fine of $500, regardless of IRS's appraisal of the actual tax due. If the IRS determined that there had been an underpayment, the penalty could be raised to 10 percent of the tax owed, plus 50 percent of the interest due on the underpayment. Basically, this provision would increase the penalty in those cases where the IRS must reconstruct a taxpayer's income because of negligent failure to maintain adequate books and records. The increased revenues from this provision are difficult to estimate; even a 2 percent reduction in the tax gap from nonfarm business, however, would raise about $500 million.

APPENDIX B. SUMMARY TABLES OF SPENDING, TAXATION, AND USER CHARGE OPTIONS BY BUDGET FUNCTION

The preceding pages of this report contain 164 deficit reduction options that are specific to particular federal programs or to provisions of the Internal Revenue Code. The tables that follow list those options by budget functions. Some options in Tables B-1 and B-2 are not assignable to any single function; they are carried at the end of those tables.

Table B-1 lists spending reduction options, Table B-2 taxation options, and Table B-3 user charge options. The page number in parentheses after the caption for each item locates the discussion of that item in the body of the report.

For each option, the tables display the estimated 1984-1988 savings or revenue gains that would result from its enactment. Both budget authority and outlay savings are shown for the spending reduction options, with the exception of Social Security proposals, where technical difficulties preclude the development of useful budget authority estimates.

These estimates do not include any secondary effects--that is, effects on spending or revenues that would occur if the performance of the economy as a whole were altered by enacting the options shown here. In addition, except where otherwise specified, the estimates generally do not reflect any offsetting or additional effects that might occur indirectly as a result of the changes under examination. Thus, for example, reductions in Social Security benefits often cause outlays for programs such as Supplemental Security Income (SSI) and Food Stamps to increase, but these offsetting increases are not reflected in the Social Security savings estimates. Major exceptions to this treatment include the estimates for the options to reduce Medicare benefits, which reflect any concurrent increase that would occur in federal Medicaid expenditures, and for the budgetary effects of the proposals made by the National Commission on Social Security Reform.

Unless specified otherwise, the estimates assume the proposals in Tables B-1 and B-3 take effect on October 1, 1983 and those in Table B-2 on January 1, 1984. The savings for the separate options cannot be added to a grand total. If all were enacted, some of the options would interact with each other in ways that would produce different savings results from those estimated for each option separately. Furthermore, many others are alternatives, only one of which could be enacted, so that adding them would produce a meaningless number.

TABLE B-1. ILLUSTRATIVE SAVINGS IN BUDGET AUTHORITY AND OUTLAYS FROM CBO BASELINE SPENDING PROJECTIONS, BY BUDGET FUNCTION, FISCAL YEARS 1984-1988 (In millions of dollars)

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
050 National Defense						
a. Cancel F/A-18, buy A-6s **(p. 39)**						
Budget Authority	-200	700	1,600	2,100	4,100	8,400
Outlays	-20	-5	400	1,200	1,900	3,500
b. Cancel DIVAD **(p. 41)**						
Budget Authority	900	800	700	400	--	2,800
Outlays	100	500	700	700	500	2,400
c. Cancel Army Scout **(p. 42)** Helicopter Program						
Budget Authority	200	300	300	500	500	1,800
Outlays	50	100	200	300	400	1,000
d. Cancel MX missile **(p. 42)**						
Budget Authority	8,200	7,000	5,400	4,000	3,200	27,800
Outlays	3,000	5,600	5,700	4,900	4,000	23,200

NOTE: An asterisk in this table indicates less than $50 million

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
050 National Defense cont'd						
e. Cut back F-15 procurement **(p. 46)**						
Budget Authority	700	1,600	2,400	2,600	2,700	9,900
Outlays	100	500	1,200	1,900	2,300	900
f. Limit expansion of K-135 re-engining **(p. 47)**						
Budget Authority	500	300	300	100	--	1,200
Outlays	100	300	300	300	200	1,100
g. Cancel DDG-51 program **(p. 49)**						
Budget Authority	100	200	400	1,900	3,500	6,200
Outlays	5	20	100	200	500	800
h. Cancel C-17 program **(p. 50)**						
Budget Authority	30	40	200	1,200	2,100	3,500
Outlays	20	30	100	400	900	1,500

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
050 National Defense cont'd						
i. Deactivate one Army division **(p. 52)**						
Budget Authority	200	400	600	600	600	2,400
Outlays	200	400	500	600	600	2,300
j. Boost Canadian NORAD support **(p. 53)**						
Budget Authority	30	40	40	40	40	200
Outlays	30	30	40	40	40	200
k. Japanese AWACS buy **(p. 54)**						
Budget Authority	200	500	600	200	-600	1,000
Outlays	20	200	400	500	300	1,300
l. Extend 1984 pay freeze **(p. 55)**						
Budget Authority	--	2,000	1,700	1,700	1,700	7,000
Outlays	--	1,900	1,700	1,700	1,700	7,000

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
050 National Defense cont'd						
m. Restructure military retired pay **(p. 56)**						
Budget Authority	--	--	300	600	900	1,900
Outlays	--	--	300	600	900	1,900
n. Limit O&M growth **(p. 58)**						
Budget Authority	700	1,500	2,600	3,800	5,100	13,700
Outlays	600	1,300	2,400	3,500	4,800	12,600
150 International Affairs						
a. Increase the share of bilateral aid provided as loans **(p. 180)**						
Budget Authority	4	12	21	33	46	115
Outlays	4	12	21	33	46	115
b. Raise interest rates on bilateral loans **(p. 180)**						
Budget Authority	7	23	48	81	123	282
Outlays	7	23	48	81	123	282
c. Decrease payments to development banks **(p. 180)**						
Budget Authority	31	31	31	31	97	219
Outlays	4	11	15	19	43	92

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
150 International Affairs cont'd						
d. Reduce Export-Import Bank aid **(p. 166)**						
Budget Authority	3,389	3,753	3,878	3,978	4,567	19,565
Outlays	334	1,608	2,614	2,971	2,934	10,461
250 General Science, Space, and Technology						
None						
270 Energy						
a. Raise interest rate on REA loans 1/ **(p. 167)**						
Budget Authority	6	23	48	70	90	237
Outlays	6	23	48	70	90	237
b. Eliminate REA loan guarantees 1/ **(p. 167)**						
Budget Authority	--	1,740	2,950	3,820	4,460	12,970
Outlays	--	1,740	2,950	3,820	4,460	12,970

1. Savings from these options appear off-budget.

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
270 Energy cont'd						
c. End CRBR funding **(p. 176)**						
Budget Authority	180	215	225	235	250	1,105
Outlays	105	190	220	230	245	990
d. Abolish the Synthetic Fuels Corporation **(p. 176)**						
Budget Authority	--	--	--	--	--	--
Outlays	21	22	23	24	25	115
300 Natural Resources and Environment						
a. End some BOR projects **(p. 172)**						
Budget Authority	300	300	300	300	300	1,500
Outlays	260	300	300	300	300	1,460
b. Reduce Corps dredging **(p. 172)**						
Budget Authority	200	200	200	200	200	1,000
Outlays	160	200	200	200	200	960
350 Agriculture						
a. End deficiency payments **(p. 139)**						
Budget Authority	--	--	1,935	3,540	3,580	9,055
Outlays	1,935	3,540	3,580	3,380	3,065	15,500

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
350 Agriculture cont'd						
b. Cap farmer-owned reserve **(p. 141)**						
Budget Authority	--	--	110	--	--	110
Outlays	110	--	--	--	--	110
c. Reduce dairy support **(p. 142)**						
Budget Authority	--	--	-985	-290	60	-1,215
Outlays	-985	-290	60	200	1,135	120
d. Restrict crop production **(p. 143)**						
Budget Authority	--	--	450	5,490	1,660	7,600
Outlays	450	5,490	1,660	1,485	985	10,070
e. End wool and mohair program **(p. 144)**						
Budget Authority	--	65	76	85	92	318
Outlays	65	76	85	92	96	414
f. End honey price supports **(p. 146)**						
Budget Authority	--	--	33	36	38	107
Outlays	33	36	38	40	41	188
g. Make peanut program no-net-cost **(p. 146)**						
Budget Authority	--	--	38	38	38	114
Outlays	38	38	38	38	38	190

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
350 Agriculture cont'd						
h. Raise interest rate on some FmHA loans **(p. 168)**						
Budget Authority	--	20	45	65	90	220
Outlays	--	20	45	65	90	220
i. End funding for overseas agricultural market development **(p. 166)**						
Budget Authority	41	43	44	45	47	220
Outlays	28	39	44	45	46	202
370 Commerce and Housing Credit						
a. Reduce rural housing subsidies **(p. 171)**						
Budget Authority	85	140	195	250	310	980
Outlays	85	140	195	250	310	980
b. End USPS revenue forgone subsidy **(p. 219)**						
Budget Authority	740	778	815	849	882	4,064
Outlays	740	778	815	849	882	4,064
c. End selected SBA business loans **(p. 167)**						
Budget Authority	160	130	105	80	60	535
Outlays	155	125	105	80	60	525

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
400 Transportation						
a. Reduce interstate highway funding **(p. 157)**						
Budget Authority	3,000	3,000	3,000	3,000	3,000	15,000
Outlays	510	2,070	2,520	2,670	2,760	10,530
b. End urban and secondary roads aid **(p. 157)**						
Budget Authority	1,450	1,450	1,450	1,450	1,450	7,455
Outlays	250	975	1,195	1,275	1,365	5,060
c. Reduce mass transit aid **(p. 160)**						
Budget Authority	1,200	1,220	1,240	1,290	1,340	6,290
Outlays	900	960	1,040	1,140	1,260	5,300
d. Reduce Amtrak funding **(p. 173)**						
Budget Authority	280	300	310	320	330	1,540
Outlays	280	300	310	320	330	1,540
e. End aid for airports not serving national needs **(p. 161)**						
Budget Authority	440	435	450	450	465	2,240
Outlays	90	285	375	420	450	1,620

TABLE B-i.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
400 Transportation cont'd						
f. End aid for self-sufficient airports **(p. 161)**						
Budget Authority	190	185	195	195	200	965
Outlays	40	125	160	185	195	705
g. Reduce NASA's aeronautical research **(p. 177)**						
Budget Authority	105	110	120	125	130	590
Outlays	40	100	110	120	125	495
h. End maritime operating subsidies **(p. 164)**						
Budget Authority	427	448	467	485	503	2,330
Outlays	425	445	464	483	501	2,318
450 Community and Regional Development						
a. Reduce CDBG eligibility **(p. 162)**						
Budget Authority	722	758	792	823	854	3,949
Outlays	14	289	679	769	802	2,553
b. Further limit UDAG eligibility **(p. 163)**						
Budget Authority	115	121	127	132	136	631
Outlays	24	45	71	98	126	364

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
500 Education, Training, Employment and Social Services						
a. Reduce elementary and secondary aid **(p. 161)**						
Budget Authority	250	265	280	295	310	1,400
Outlays	20	165	260	275	290	1,010
b. Reduce VocEd aid **(p. 162)**						
Budget Authority	260	270	285	300	315	1,430
Outlays	35	190	265	285	300	1,075
c. Reduce GSL lender allowance **(p. 131)**						
Budget Authority	*	*	100	100	100	400
Outlays	*	*	100	100	100	300
d. Reduce GSL subsidy for professions students **(p. 128)**						
Budget Authority	*	100	100	200	200	500
Outlays	*	*	100	200	200	500
e. Reduce campus-based student assistance **(p. 169)**						
Budget Authority	170	175	185	195	205	930
Outlays	10	160	175	185	195	725

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
500 Education, Training, Employment and Social Services cont'd						
f. Reduce subsidies for the Arts and Humanities **(p. 171)**						
Budget Authority	58	61	63	65	68	315
Outlays	31	60	62	64	67	284
g. Target Administration on Aging programs **(p. 163)**						
Budget Authority	70	75	80	80	85	390
Outlays	50	65	75	80	85	355
550 Health						
a. Expand hospital coinsurance under Medicare **(p. 103)**						
Budget Authority	-190	-520	-800	-1,070	-1,370	-3,950
Outlays	1,980	3,010	3,400	3,820	4,290	16,490
b. Same as a. but with out-of-pocket cost cap for some **(p. 103)**						
Budget Authority	-70	-240	-400	-550	-720	-1,980
Outlays	1,190	1,820	2,050	2,320	2,700	10,080

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
550 Health cont'd						
c. Increase Medicare SMI premium **(p. 106)**						
Budget Authority	900	1,120	1,700	2,460	3,370	9,550
Outlays	900	1,120	1,700	2,460	3,370	9,550
d. Same as c. for high-income families only **(p. 107)**						
Budget Authority	240	300	450	650	890	2,530
Outlays	240	300	450	650	890	2,530
e. Adopt Medicare prospective hospital reimbursement **(p. 108)**						
Budget Authority	--	--	-80	-300	-580	-960
Outlays	--	--	2,140	4,100	4,610	10,850
f. Limit Medicare reasonable charge growth **(p. 110)**						
Budget Authority	40	260	670	1,200	1,830	4,000
Outlays	10	190	590	1,100	1,730	3,620
g. Adopt Medicare surgical fee schedules **(p. 111)**						
Budget Authority	170	700	810	940	1,100	3,720
Outlays	180	680	790	920	1,070	3,640

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
550 Health cont'd						
h. Extend cuts in matching Medicaid grants **(p. 112)**						
Budget Authority	--	870	660	840	1,040	3,410
Outlays	--	870	660	840	1,040	3,410
i. End indirect subsidy for USPS annuitants **(p. 199)**						
Budget Authority	450	480	520	550	590	2,590
Outlays	450	480	520	550	590	2,590
600 Income Security						
a. Enact NCSSR benefit proposals **(p. 86)**						
Outlays	2,900	3,100	3,500	3,700	4,000	17,200
b. Delay 1983 OASDI COLA by three months **(p. 70)**						
Outlays	2,000	2,100	2,100	2,100	2,100	10,400

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
600 Income Security cont'd						
c. Cap OASDI COLA at CPI rise minus 2 percentage points **(p. 70)** Outlays	4,200	7,800	11,500	15,300	19,100	57,900
d. Eliminate 1983 OASDI COLA Outlays **(p.70)**	6,800	6,900	6,900	6,700	6,400	33,700
e. Eliminate 1983 and 1984 OASDI COLAs **(p. 70)** Outlays	8,800	14,800	14,800	14,600	14,100	67,100
f. Change OASDI benefit formula **(p. 74)** Outlays	*	100	200	300	600	1,200
g. Lengthen OASDI benefit computation period by three years **(p. 75)** Outlays	*	100	300	500	700	1,600

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
600 Income Security cont'd						
h. Eliminate OASDI benefits for early retirees' children **(p. 77)**						
Outlays	*	200	300	500	600	1,600
i. Apply DI family maximum to OASI benefits **(p. 78)**						
Outlays	100	200	400	600	800	2,100
j. Lengthen DI waiting period by one month **(p. 78)**						
Outlays	200	200	200	200	200	1,000
k. Modify Civil Service Retirement benefits **(p. 195)**						
Budget Authority	--	150	350	500	700	1,700
Outlays	170	560	1,200	1,700	2,270	5,900
l. Revamp CSR system **(p. 196)**						
Budget Authority	-100	-300	-500	-700	-900	-2,500
Outlays	--	100	200	300	300	900

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
600 Income Security cont'd						
m. Eliminate CSR 1984 COLA **(p. 193)**						
Budget Authority	--	400	400	300	300	1,400
Outlays	250	850	850	900	950	3,800
n. Limit CSR COLAs for past overcompensation **(p. 198)**						
Budget Authority	--	100	200	300	400	1,000
Outlays	70	250	520	760	990	2,590
o. End USPS COLA subsidy **(p. 199)**						
Budget Authority	--	20	40	60	60	180
Outlays	60	220	500	720	950	2,450
p. Reduce child nutrition subsidy for non-poor **(p. 129)**						
Budget Authority	300	300	300	300	300	1,500
Outlays	300	300	300	300	300	1,500
700 Veterans Benefits and Services						
a. End compensation for low-rated disabilities **(p. 128)**						
Budget Authority	2,000	2,100	2,200	2,300	2,400	10,900
Outlays	1,800	2,100	2,200	2,300	2,300	10,700

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
700 Veterans Benefits and Services cont'd						
b. Require copayments for VA health care **(p. 169)**						
Budget Authority	160	190	245	300	355	1,250
Outlays	160	190	245	300	355	1,250
750 Administration of Justice						
End juvenile justice and delinquency grants **(p. 163)**						
Budget Authority	74	77	81	84	88	404
Outlays	17	51	72	80	84	304
800 General Government						
None						
850 General Purpose Fiscal Assistance						
Provide GRS to fiscally distressed localities only **(p. 130)**						
Budget Authority	1,400	1,500	1,600	1,700	1,700	7,900
Outlays	1,100	1,500	1,600	1,600	1,700	7,600

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
All Functions						
a. Freeze federal civilian pay in 1984 **(p. 193)**						
Budget Authority	2,650	3,025	3,175	3,330	3,500	15,680
Outlays	2,660	3,135	3,300	3,450	3,630	16,175
b. Delay within-grade pay increases						
Budget Authority **(p. 190)**	300	600	1,100	1,800	2,500	6,300
Outlays	300	600	1,100	1,800	2,500	6,300
c. Index federal pay to CPI **(p. 192)**						
Budget Authority	670	870	1,080	1,480	2,060	6,160
Outlays	680	900	1,100	1,500	2,100	6,280
d. Increase contracting out **(p. 201)**						
Budget Authority	80	260	580	930	1,160	3,010
Outlays	20	70	200	340	460	1,090
e. Improve federal office space use **(p. 182)**						
Budget Authority	10	50	95	140	190	485
Outlays	10	50	95	140	190	485

TABLE B-1.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Savings
All Functions cont'd						
f. Refocus work of national laboratories **(p. 177)**						
Budget Authority	550	575	600	625	650	3,000
Outlays	275	565	590	615	640	2,685
g. Change Davis-Bacon wage requirement **(p. 183)**						
Budget Authority	95	100	105	110	115	530
Outlays	30	60	80	90	100	365
h. Require cost-sharing for grant increases **(p. 157)**						
Budget Authority	490	790	1,150	1,510	1,880	5,820
Outlays	150	400	750	1,110	1,470	3,880

TABLE B-2. ILLUSTRATIVE REVENUE GAINS OVER CBO BASELINE PROJECTIONS, BY BUDGET FUNCTION, FISCAL YEARS 1984-1988
(In billions of dollars)

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
050 National Defense						
None						
150 International Affairs						
Phase out DISCs **(p. 271)**	*	0.2	0.3	0.5	0.6	1.7
250 General Science, Space, and Technology						
Reduce research tax credit **(p. 273)**	0.3	0.5	0.2	*	*	1.0
270 Energy						
a. Repeal oil and gas percentage depletion **(p. 275)**	0.9	1.7	1.9	2.0	2.2	8.7
b. Repeal expensing of oil and gas intangible drilling costs **(p. 276)**	2.6	4.5	4.2	4.1	3.9	19.3

NOTE: An asterisk in this table indicates less than $50 million.

TABLE B-2.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
270 Energy cont'd						
c. Repeal residential energy tax credits **(p. 278)**	0.1	0.9	1.0	0.1	*	2.0
d. Repeal business energy tax incentives **(p. 280)**	0.3	0.5	0.5	0.5	0.5	2.3
300 Natural Resources and Environment						
a. End capital gains treatment of timber **(p. 282)**	0.2	0.6	0.7	0.8	0.8	3.1
b. End pollution control bond tax exemption **(p. 283)**	*	0.1	0.2	0.4	0.5	1.2
350 Agriculture						
None						
370 Commerce and Housing Credit						
a. Cap nonbusiness interest deduction at $10,000 **(p. 284)**	0.6	1.8	2.0	2.2	2.4	9.0

TABLE B-2.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
370 Commerce and Housing Credit cont'd						
b. Tax 10 percent of home sale capital gain **(p. 286)**	--	0.8	1.0	1.2	1.4	4.4
c. Require 20 year life for building depreciation **(p. 288)**	0.4	1.8	3.7	5.7	7.7	19.3
d. Tax accrued interest on life insurance reserves **(p. 290)**	2.1	5.8	6.6	7.6	8.7	30.8
e. Repeal net interest exclusion **(p. 292)**	--	1.1	3.0	3.4	3.7	11.2
f. End small issue IRB tax exemption **(p. 294)**	*	0.3	0.7	1.2	1.5	3.7
g. Limit deduction for business meals and entertainment **(p. 296)**	0.5	1.1	1.2	1.4	1.5	5.7
h. Require full basis adjustment for ITC **(p. 298)**	0.3	1.2	2.4	3.6	4.9	12.4
i. End accumulated earnings allowance for PSCs **(p. 299)**	0.1	0.4	0.4	0.5	0.5	1.9

TABLE B-2.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
400 Transportation						
None						
450 Community and Regional Development						
Repeal building rehabilitation tax credit **(p. 301)**	0.8	1.2	1.4	1.6	1.8	6.8
500 Education, Training, Employment and Social Services						
a. Repeal extra parental exemption for students **(p. 302)**	0.3	0.8	0.8	0.9	0.9	3.7
b. Tax nonstatutory fringe benefits **(p. 303)**	0.6	1.2	1.3	1.5	1.8	6.4
c. Cap charitable deduction for non-itemizers at $100 **(p. 304)**	--	0.2	1.9	3.6	--	5.7
d. End ESOP credit **(p. 306)**	0.7	1.7	2.1	2.3	1.1	7.8

TABLE B-2.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
550 Health						
a. Tax some employer-paid health insurance **(p. 308)**						
Income Tax	2.7	4.9	6.0	7.2	8.7	29.6
Payroll Tax	0.8	1.5	1.9	2.2	2.6	9.1
b. Tax premiums for supplemental Medicare coverage **(p. 107)**	2.4	3.6	4.2	4.8	5.5	20.5
c. End tax exemption for hospital bonds **(p. 310)**	0.1	0.3	0.6	0.9	1.1	3.0
600 Income Security						
a. Enact NCSSR revenue proposals **(p. 87)**	9.4	5.7	8.8	10.1	22.5	56.5
b. Tax half of Social Security benefits for recipients with incomes above $12,000/$18,000 **(p. 79)**	1.7	5.8	6.6	7.4	8.2	29.7

NOTE: Function 600 items a. through h. reflect estimated reductions in the unified budget deficit rather than increases in trust fund receipts.

TABLE B-2.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
600 Income Security cont'd						
c. Advance 1985 Social Security tax rate rise to January 1984 (p. 71)	6.4	2.3	--	--	--	8.7
d. Advance 1985 and 1990 Social Security tax rate rises to January 1984 (p. 71)	19.1	19.2	18.1	19.3	20.8	96.6
e. Raise self-employed Social Security tax rate (p. 81)	0.4	1.3	1.4	1.5	1.6	6.2
f. Extend OASDI to federal workers with less than five years' service and all future hires (p. 82)	0.6	1.0	1.3	1.6	1.9	6.4
g. Cover new state/local employees under Social Security (p. 84)	0.1	0.2	0.4	0.5	0.7	1.9
h. Cover employees of all nonprofit organizations under Social Security (p. 85)	0.9	1.3	1.6	1.8	2.1	6.7

TABLE B-2.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
600 Income Security cont'd						
i. Tax 40 percent of railroad retirement benefits (p. 123)	0.5	0.7	0.8	0.8	0.8	3.6
j. Tax workers' compensation benefits (p. 126)	1.5	2.4	2.8	3.2	3.6	13.5
k. Tax all unemployment insurance (UI) benefits (p. 123)	*	1.7	1.6	1.7	1.6	6.6
l. Index UI tax base (p. 122)	0.9	1.8	2.8	3.9	5.4	14.8
m. Eliminate extra blind/elderly exemption (p. 311)	1.0	2.5	2.6	2.8	2.9	11.8
n. Eliminate income averaging (p. 312)	3.5	3.8	4.2	4.5	4.9	20.9
o. Freeze estate/gift tax credit at exemption equivalent of $275,000 (p. 314)	--	0.5	1.1	1.8	2.6	6.1

TABLE B-2.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
700 Veterans Benefits and Services						
Tax Veterans' Compensation benefits **(p. 125)**	1.1	1.8	1.8	1.8	1.8	8.4
750 Administration of Justice						
None						
800 General Government						
None						
850 General Purpose Fiscal Assistance						
End state and local sales tax deduction **(p. 315)**	0.9	5.8	6.4	7.0	7.8	27.9
Options Not Assignable To a Function						
a. Improve taxpayer compliance **(p.317)**	1.2	2.1	4.2	4.7	5.2	17.3
b. Repeal July 1, 1983 rate reduction **(p. 233)**	30.0	33.0	35.0	38.0	40.0	177.0
c. Cap third-year tax rate cut at $700 **(p. 235)**	6.0	7.0	7.0	8.0	9.0	37.0
d. Repeal ERTA income tax indexing **(p. 236)**	--	6.0	17.0	28.0	40.0	90.0

TABLE B-2.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
e. Impose 10 percent individual income tax surtax (p. 241)	15.0	33.0	36.0	38.0	41.0	163.0
f. Impose 10 percent corporate income tax surtax (p. 242)	4.0	8.0	9.0	10.0	11.0	42.0
g. Extend cigarette excise tax (p. 257)	--	--	1.7	1.7	1.7	5.1
h. Extend telephone excise tax (p. 259)	--	--	1.3	2.3	2.7	6.3
i. Double excise tax on alcohol (p. 259)	2.5	4.0	4.0	4.0	4.1	18.6
j. Impose excise tax on luxuries (p. 259)	0.2	0.3	0.4	0.4	0.4	1.7
k. Impose $2 oil import fee (p. 252)	3.1	4.4	4.3	4.3	4.3	20.4
l. Impose broad-based domestic energy tax (p. 254)	11.3	17.2	18.5	20.0	21.6	88.6
m. Impose tax on domestic and imported oil (p. 254)	5.9	8.5	8.5	8.5	8.5	39.9
n. Impose natural gas excise tax (p. 255)	2.1	3.0	3.0	3.0	3.0	14.1
o. Increase gasoline excise tax (p. 256)	2.9	4.1	4.1	4.2	4.2	19.5

TABLE B-3. ILLUSTRATIVE ADDED USER CHARGE COLLECTIONS OVER CBO BASELINE PROJECTIONS, BY BUDGET FUNCTION, FISCAL YEARS 1984-1988 (In millions of dollars)

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
050 National Defense						
None						
150 International Affairs						
None						
250 General Science, Space, and Technology						
Raise space shuttle charges **(p. 223)**	73	237	394	373	303	1,380
270 Energy						
a. Raise federal power rates to recover actual costs **(p.216)**	41	43	53	59	61	257
b. Charge for SPR construction/storage costs **(p.218)**	300	300	300	300	300	1,500
c. Charge for FERC permits **(p.223)**	37	38	38	39	40	192

TABLE B-3.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
300 Natural Resources and Environment						
a. Raise inland waterways user charge **(p.212)**	700	700	750	750	800	3,700
b. Enact deep-draft navigation user charge **(p.213)**	500	500	500	500	550	2,550
c. Raise BOR irrigation water prices **(p.215)**	--	3	3	3	3	12
d. Auction grazing rights on federal land **(p.215)**	3	6	9	15	20	53
e. Raise federal recreation area charges **(p.216)**	30	60	94	97	100	381
f. Raise NOAA chart and map prices **(p.221)**	44	44	44	44	44	220
350 Agriculture						
None						
370 Commerce and Housing Credit						
a. Raise patent and trademark fees **(p.220)**	8	8	8	9	9	42

TABLE B-3.

Budget Function/Options	1984	1985	1986	1987	1988	Cumulative Five-Year Gains
370 Commerce and Housing Credit cont'd						
b. Enact CFTC user charge (p. 223)	23	24	24	25	26	122
400 Transportation						
a. End all highway user tax exemptions (p. 210)	680	680	680	680	680	3,400
b. Fund all highway programs from user charges (p. 210)	400	400	400	400	400	2,000
c. Raise fees from general aviation (p. 211)	1,070	1,100	1,130	1,070	1,070	5,440
d. Enact user charge for Coast Guard services (p. 214)	1,090	1,120	1,150	1,190	1,220	5,770
450 Community and Regional Development						
None						
500 Education, Training, Employment and Social Services						
None						

TABLE B-3.

Budget Function/Options	**1984**	**1985**	**1986**	**1987**	**1988**	Cumulative Five-Year Gains
550 Health						
None						
600 Income Security						
None						
700 Veterans Benefits and Services						
None						
750 Administration of Justice						
None						
800 General Government						
Charge for requested IRS rulings and determinations (p. 221)	13	13	14	15	15	70
850 General Purpose Fiscal Assistance						
None						